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Mission MATTERS

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Confront the **tough, strategic** issues

a commonfund editorial

How many times have we heard over the past few months that we are experiencing the greatest financial crisis since the Great Depression? We will not know if this is true until the end game unfolds and the economic historians have torn apart the facts, circumstances and outcomes in gory detail. In the meantime, we have to live through these "historic" times and deal with the challenges that are presented to us on a daily basis.

There are, however, several aspects of this crisis that are abundantly clear and clearly different than past economic contractions. One of the differences is the likely larger impact on nonprofit institutions. In fact, the challenges faced by nonprofits could very well create a feedback loop that worsens the economic slowdown. Why? The simple answer is that the nonprofit sector has become an increasingly important part of the U.S. economic landscape and today provides significantly more in terms of social services than in prior recessionary periods.

Let's review some of the facts. Over the last 10 years the number of nonprofits has grown by 30 percent to 1.9 million. Nonprofit assets have grown 90 percent to $3 trillion. Included in these numbers is continued growth in giving, reaching $306 billion in 2007. The nonprofit sector contributes 5.2 percent to GDP, employs 10.8 percent of Americans and pays 8.3 percent of all wages. Further reflecting the mounting importance of the sector, from 2002 to 2004 nonprofit employment grew 5 percent while employment growth in the rest of the economy was slightly negative.

The physical evidence of the increased importance of nonprofits is everywhere. Over the last decade it has been difficult to tour a college campus or a large healthcare organization without seeing major construction projects underway. In many American cities, this contrasts to reduced activities in other sectors. The boom has been fueled by changing demographics, higher revenues and increasing contributions, only modest leveraging of balance sheets, strong asset growth owing to effective endowment management, and relatively vibrant financial markets.

Most of these factors have quickly and dramatically reversed over the last six months and in all likelihood we will not go back to "business as usual" for some time.

The changing financial condition

We have seen endowments experience a significant decline almost across the board. After an average negative 2.5 percent return for the year ended June 30, 2008 (Source: the Wilshire Trust Universe Comparison Service [TUCS]), it is likely that virtually all have experienced "unprecedented losses" since that time—as Harvard has recently warned with regard to its portfolio. One of the most challenging aspects of this downturn is the total lack of a place to hide. It seems that, at least temporarily, the old tenet of diversification has been suspended. Yet even when correlations have "gone to one" in the past, recoveries have been relatively quick and the impact on nonprofits has been modest in general since most institutions have a smoothing mechanism in place. However, with most institutions projecting declining average assets over a multi-year period, the nonprofit community faces a protracted decrease in endowment distributions. These market conditions will affect all institutions. Those with higher levels of endowment support will feel the impact from these market conditions to a greater degree, with the largest "hit" impacting foundations that are entirely dependent on investments to fund grants.

As it relates to endowment spending, trustees need to question whether, under these circumstances, maintaining spending levels regardless of the spending formula makes sense. Commonfund has advocated vocally for long-term formulas that provide for sensible spending at around 5 percent in order to maintain intergenerational equity. We have also recommended smoothing formulas that take inflation into account to help balance the investment risk of the asset pools with risks that threaten missions. But in today's reality, this convergence of factors may require trustees to re-examine spending in a way that ensures the mission is not jeopardized.

A second key factor that will likely impact nonprofits is reduced giving. Historically, market turbulence and poor economic conditions have had a negative impact on giving. As we examine historical data it is clear that giving drops when markets are troubled. In the

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Verne Sedlacek,
President and CEO,
Commonfund

period from 2000 to 2002, overall giving declined 3 percent before bouncing back over the next several years. In 1987, gifts to charities dropped 4.5 percent. Again, the bounce-back was rapid when conditions improved. Institutions will be affected differently depending on the strength of their donor bases, but until market uncertainty is relieved the giving pool will shrink.

The third major area of trouble is debt financing. Universities and nonprofit healthcare organizations have used the debt markets to finance renovation and expansion. Many have utilized the monoline insurers to improve credit ratings and reduce debt service costs. But, the monoline insurers are under enormous stress and have had their credit ratings lowered; and the markets are largely closed to new issues at any price. Compounding the problem is the number of organizations that used floating rate debt and auction rate preferred notes, both of which were swapped to long-term debt. The adjusted cost of the current financing has increased substantially for even the most creditworthy of nonprofits. Based on our view of the markets and the enormous flight to quality, it will be quite some time before these markets improve.

Market actions impair liquidity

Overall access to liquidity has been further impaired by a host of related market actions. Endowments, for example, have become less liquid as hedge funds have restricted redemptions and stock lending proceeds have locked up. Even historically liquid investments like the Commonfund Short Term Fund have been impacted with the decision by Wachovia Bank as trustee to gate a fund that had operated continuously for 34 years. We are very disturbed that this fund, on which the educational community has relied for liquidity, exacerbated an already very difficult situation.

A fourth issue changing the financial landscape for nonprofits is the outlook for reduced spending at the state and federal government level. A vast majority of state governments are looking at significant deficits, and the federal government is on the way to an estimated $1 trillion deficit next year (which is likely a lowball estimate). This means cutbacks in state funding of higher education and loan programs. On the federal level we will continue to get squeezes in Medicare reimbursement levels, perhaps at an accelerated rate. And, research funding and, possibly, student loan programs could be under stress.

Regarding the latter, we are seeing a significant reduction in sources of student and parent loan programs. While the federal government has to date maintained its commitment to student loans, some states have begun to cut back. In addition, other nongovernmental loan opportunities have basically ceased to exist. Banks are not lending to anyone: no parent loans, no graduate school loans, no second mortgages. Based on discussions with many educational institutions, this lack of available financial support—combined with reduced resources for direct aid—has not yet impacted matriculation. But, many are worried this lack of funding will begin to impact enrollment levels in the second semester of this academic year and beyond.

Healthcare organizations will be challenged to find other sources of revenue, and universities will be hard-pressed to raise tuition and maintain enrollments.

We are just now beginning to witness the impact of these converging factors. A number of educational institutions have announced hiring freezes and suspension of construction projects, and all institutions will need to make difficult choices in the coming months.

Needless to say, the picture I have painted is not pretty. Boards and administrations face a balancing act as they confront these difficult decisions while remaining true to the missions of their organizations. There is no "bailout" for nonprofits coming from the Treasury or the Fed. Nonprofit, mission-based organizations will survive these tough times and will rationalize their cost structures to deal with the realities imposed by market forces. While it will be harder this time than it has been in the past, those institutions that make the tough strategic decisions will be rewarded.

—Verne Sedlacek

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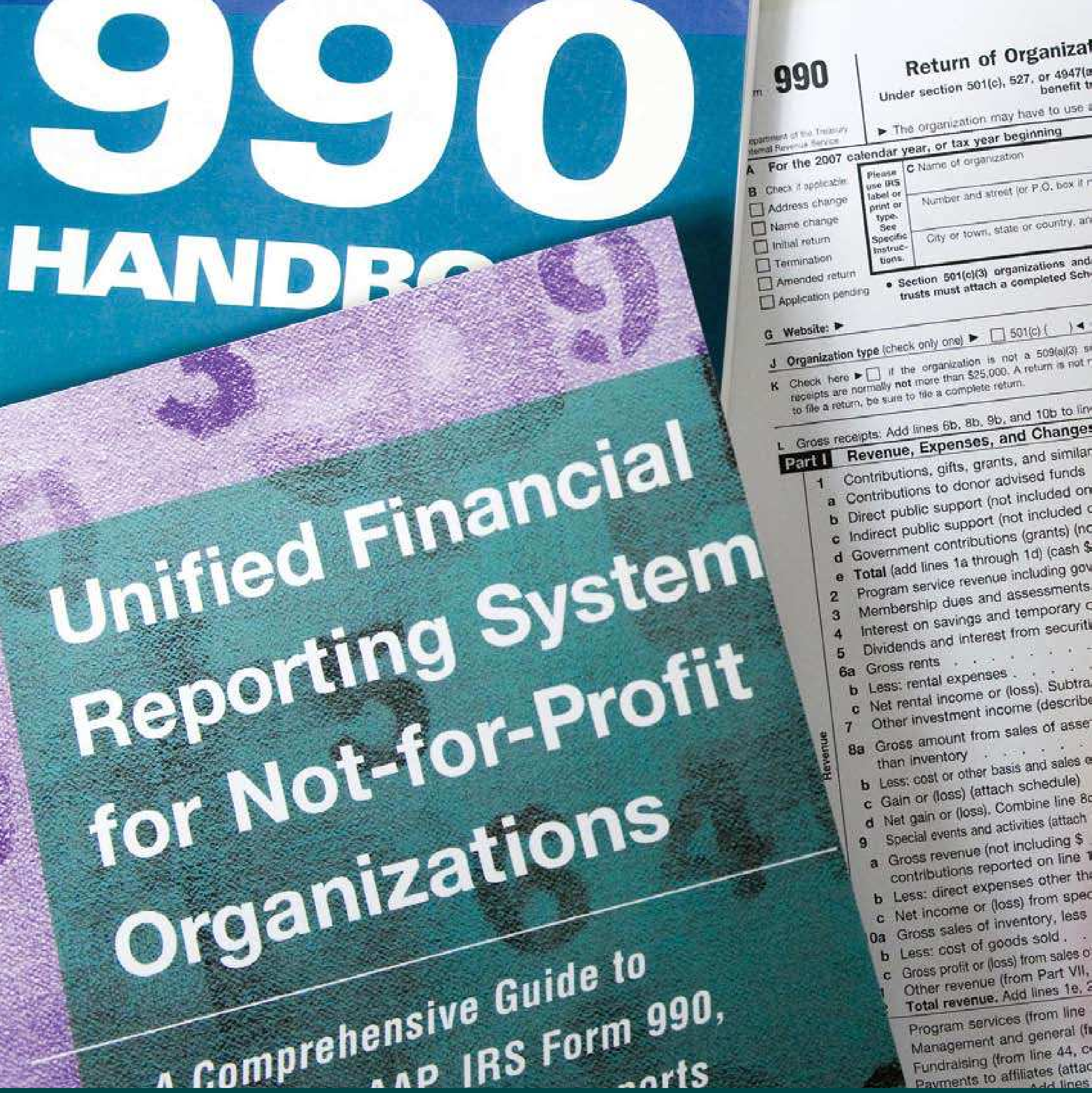

The nonprofit sector's **new report card**

Governance and the revised IRS Form 990: New roles for trustees

by Tom Hyatt

The quest for good governance in the nonprofit sector has received more thoughtful attention in the last five years than ever before. Charity governance standards organizations, watchdog groups, states' attorneys general and Congress all have had their say. Now, the quest has been joined by an unlikely ally that may prove to be the most influential of them all: the Internal Revenue Service.

Most trustees and directors of nonprofit organizations likely do not associate the realization of the core governance principles of accountability, transparency and compliance with the completion of Form 990, the Internal Revenue Service (IRS) information return that is filed each year by most tax-exempt organizations. It is often dismissed by trustees as a tax form, best left to accountants, the chief financial officer and the audit committee. With the introduction in 2008 of the IRS' all-new Form 990, the time has come to discard those notions and to accept and embrace the role that directors must play in enabling their organization to prepare the new 990 in a manner that effectively demonstrates that the organization is well governed. As is often the case, the journey to that result is of greatest importance here. It is an opportunity for the board of trustees to more fully understand and give needed direction to the organization they serve.

In December 2007, the IRS issued its redesigned Form 990. It had previously released a discussion draft, and solicited and incorporated many public comments in a commendably collaborative effort with the nonprofit sector. The use of the form dates back to the 1940s; however, in the view of the IRS, the existing 990 failed to reflect important changes in the law affecting nonprofits and the increasing size, diversity and complexity of the tax-exempt sector. It can fairly be said that the existing Form 990 is inadequate to illuminate the inner workings of exempt organizations or to permit peer comparisons to the extent desired by the IRS, the public and exempt organizations themselves. Accordingly, the IRS launched an extensive effort to redesign Form 990 to capture relevant information about the modern tax-exempt organization.

Make no mistake about it, this redesign is revolutionary. According to the IRS, it is intended to provide greater transparency, promote compliance and lessen the burden on the filing organization. (Two out of three ain't bad.) Here are eight things nonprofit directors should know now about the new Form 990 and how it will affect their organization.

1. This is much more than a tax form.

If you ever were of the mind that the Form 990 was a tax document that didn't require board involvement, it is time to change your point of view. The IRS uses the 990 as its primary tax compliance tool for tax-exempt organizations. It is a public record document, readily available on the Internet. Most states also rely on the form to perform charitable and other regulatory oversight. Moreover, the new Form 990 is so much more than a financial reporting document. It contains questions designed to delve deeply into the governance processes of the organization, its compensation mechanisms and its operating policies. Certainly, the financial disclosures remain a key portion of the form, including all-new disclosures about compensation and endowments. However, it is essential that the board goes through the exercise of answering the governance-related questions and making informed choices about which practices and policies to adopt so as to ensure effective governance.

2. This is not your grandfather's Form 990.

The original Form 990 was two pages long. The new Form 990 has a core form that is 11 pages long and may include up to 16 schedules. In its public comments to the IRS on the redesigned 990, the National Association of College and University Business Officers

Make no mistake about it, this redesign is revolutionary.

(NACUBO) predicted that many large and mid-sized institutions will need to add one full-time administrative position for collecting and reporting data required by the new form. While the burden on filing organizations will surely increase, notwithstanding the IRS' goal to the contrary, that burden is not management's alone. There is meaningful governance work to be done by boards in preparing the responses that are called for in the expanded scope of the form.

3. The clock is ticking.

The final redesigned Form 990 is in effect now. It applies to a tax-exempt organization's 2008 tax year, which is the fiscal year of the organization that begins in 2008. Accordingly, organizations with a calendar fiscal year had only until the end of 2008 to implement needed governance policies identified in the form; those with fiscal years ending on June 30 have less than a year. The relevant deadline here is the end of the organization's 2008 fiscal year, not the form's filing deadline. Governance policies inquired about by the IRS include: conflicts of interest, protection of whistleblowers, document retention and destruction, compensation policy and practice, joint ventures, chapters and affiliates, expense payments and reimbursements, gift acceptance, compensation review, and Form 990 review. Adoption, or even review and updating, of these policies is too important to cram into the already full agenda of a year-end board meeting. These deliberations should have taken place by now, and in a thoughtful and thorough manner. More than one board or committee meeting may well be required.

4. The board of trustees will be more involved in review of the form.

Typically, Form 990 is prepared by the organization's finance staff or its external accountants. While these professionals will still have the heavy lifting responsibilities for much of the form, it is critical that the organization's board be involved in the process with respect to the governance and operational questions raised by the form. Perhaps the most important governance questions on the new Form 990 are these: Was Form 990 provided to the board before it was filed? What is the process the institution uses to review Form 990?

The IRS does not require prior *approval* of the 990 by the board and there is no legal penalty for the failure of a board to do so. However, these questions point out the need of the board of directors to be conversant in the information presented in the Form 990. While prior review may pose some logistical problems when filing deadlines get tight, this role is vital and a fiduciary duty of the board under its duty of care.

The obligation to describe the organization's Form 990 review process begs the question: Do we even have such a process? If you don't, you're in good company. In a 2007 Grant Thornton survey, *National Board Governance Survey for Not-for-Profit Organizations,* 70 percent of the respondents had not established a policy for board members to review the organization's Form 990. Clearly, this is a new role for nonprofit boards and some trial and error will no doubt be necessary as the board and management work through what such a review should entail.

Many of those commenting to the IRS suggested that this duty could be fulfilled through review by a board committee, such as the audit committee. And, indeed, the IRS alludes to the acceptability of this practice in the new form's instructions. But, to consign review of the governance-related responses solely to a board committee is to miss an important opportunity for the organization to receive essential, hands-on leadership from all of its trustees or directors.

5. The new Form 990 may elevate some governance best practices to de facto requirements.

Throughout the form, questions are asked with respect to whether the organization has various governance policies in place or whether it follows particular "good governance" practices. For example, Part VI of the core form is entirely dedicated to statements regarding governance, management and disclosure. It asks the following questions:

- How many voting members are on the governing body? How many of them are independent?
- Does the organization have a written conflict of interest policy?
- Does the organization have a written whistleblower policy?
- Does the organization have a written document retention and destruction policy?
- Does the organization contemporaneously document the meetings of the governing body and its committees?
- If the organization has local chapters, branches or affiliates, does it have written policies and procedures governing their activities to ensure that their operations are consistent with the organization's?
- How do you make the following available to the public: governing documents, conflict of interest policy, Forms 1023, 990 and 990-T, and financial statements?

The IRS has stated in Form 990 that the governance policies addressed are not required by the Internal Revenue Code. While most of the best practices suggested by the new form have found widespread acceptance in recent years, there is not universal agreement on the need for these practices for all nonprofit organizations or on how they should be implemented. What are the consequences of answering "no" to whether the organization has adopted these policies? Trustees should be prepared to explain the governance choices they have made in such cases and should avoid allowing the 990's default choices to establish best practices without careful deliberation regarding what works best in their own organization.

6. Be ready to discuss your endowment funds.

A new Schedule D, Supplemental Financial Statements, has been included in the new Form 990. The schedule calls for disclosure of certain financial information regarding the endowment funds of exempt organizations, including the amount of contributions, earnings and losses, expenditures for facilities and programs, and administrative expenses, both for the current year and a four-year look-back period.

The value of requiring such disclosures in the absence of a meaningful basis for comparing the reported amounts between institutions is questionable. This issue is likely more germane to higher education organizations than to any other member of the exempt community. Institutions of higher education vary greatly in the size of their endowments, and the rate of spending of investment earnings on such funds varies for a multitude of reasons unique to each institution. These include building new facilities, recruitment of faculty, student financial aid, increases or decreases in enrollment, and investment return. Also, based on higher education surveys, over 90 percent of endowment funds are donor-restricted. Again, this imposes spending constraints that are unique to each institution; valid comparisons of institutions based on a general expenditures disclosure are elusive.

Nevertheless, educational institutions operate in a time of increasing scrutiny of their endowments and Congress is weighing new restrictions, taxes and mandatory payouts. Trustees should be prepared to answer public questions that will arise from these disclosures and to have a dialogue with their institution's administration regarding the significance of the variance in results among higher education institutions.

7. Be ready to discuss executive compensation.

It is now clear to trustees of tax-exempt organizations that the compensation of the president and senior leadership has been the subject of increasing scrutiny by regulators, Congress and charity watchdog groups. With the advent of the new Form 990, we will surely see that trend continue; however, it should lead to a more informed and reasoned discussion of compensation and a more legitimate comparison between institutions.

Part VII of the core form requires disclosure of compensation to officers, directors, trustees and key employees from the organization and its related organizations. The new Schedule J, Supplemental Compensation Information, requires disclosure of compensation for these individuals that is broken down in greater detail than ever before required of tax-exempt organizations. Disclosure is mandated not only for base compensation, but also for bonuses and incentives, severance and change in control payments, first-class travel, spousal travel, club fees, housing allowances, supplemental nonqualified retirement plans, and equity-based compensation.

With this level of disclosure, all trustees and directors, not just those who serve on the compensation committee, will need to more fully understand the compensation mechanisms of the institution and be prepared to respond to questions that result from these disclosures.

8. The ascendancy of the independent trustee or director.

No doubt drawing from the reforms instituted for publicly traded firms in the wake of the Sarbanes-Oxley Act of 2002, the new Form 990 shines the spotlight on the presence of independent trustees or directors serving on the board. The first page of the new form, intended to act as a snapshot of critical data that can easily be compared between institutions, specifically asks how many independent voting members serve on the governing body. This answer is drawn from Part VI of the form, which also inquires about family and business relationships between directors, officers and key employees. Independence in this context is generally defined as not receiving compensation from or doing business with the organization or related organizations beyond a specified threshold.

The IRS has long required that tax-exempt healthcare organizations have "community boards" with independent directors in the majority. Clearly, the new 990 reveals the IRS' view of the importance of independent board members in securing compliance with tax exemption rules for all tax-exempts.

The implementation of the new Form 990 should be embraced by all tax-exempt organizations as an opportunity to improve transparency and achieve greater accountability. Those that do so will strengthen their ability to achieve their missions and sustain the public's support. More than ever, Form 990 will serve not as a tax form but as a report card. Trustees and directors should ensure that they are proud to show it off.

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Connecting the dots: Managing risk in an environment of unprecedented uncertainty

by Bill Martin
Chief Risk Officer, Commonfund

"May you live in interesting times."

While this proverb—or curse—might not have been directed originally at a risk manager, or at anyone involved with investment management, it certainly applies to our lives in today's turbulent market environment. For the past 18 months, we have been living through an unprecedented period of intense strategic, market, credit, liquidity and operational risk that has challenged the risk management frameworks of all market participants. If we examine a sampling of the events that we have lived through recently, we can conclude that any single event, taken in isolation, would have resulted in a period of unexpected volatility in the markets:

- Sub-prime mortgages deteriorate
- Extension of asset-backed commercial paper
- Default of structured investment vehicles (SIVs)
- Closing of institutional money funds
- Takeover of Countrywide by Bank of America
- Collapse of Bear Stearns, takeover by JPMorgan Chase
- Rescue of Fannie and Freddie
- Bankruptcy of Lehman Brothers
- Takeover of Merrill Lynch by Bank of America
- Conversion of Goldman Sachs and Morgan Stanley to bank holding companies
- Explosion in credit default swap spreads
- Collapse of Washington Mutual
- Attempted takeover of Wachovia by Citigroup
- Defeat of the U.S. Treasury's $700 billion support bill by the House of Representatives
- Passing of U.S. Treasury's $700 billion support bill by Senate
- Takeover of Wachovia by Wells Fargo
- Passing of the $700 billion support bill by the House
- Coordinated infusion of capital into financial institutions by global central banks
- Government loans $85 billion to AIG
- Oil trades below $50; commodities collapse; U.S. dollar soars
- Government rescues Citigroup

When looked at collectively, it becomes clear that these events coalesce into what is a unique phenomenon, whereby chronic contagion has resulted in the destabilization of normal investment flows, a vacuum of illiquidity and the weakening of the capital base of all banks, brokers and investment managers. The level of uncertainty and unpredictability created by these events has undermined confidence in the risk management techniques built for normal market environments and for stress and scenario analyses that are related to historical experience.

Collaboration and open dialogue across all functions are essential.

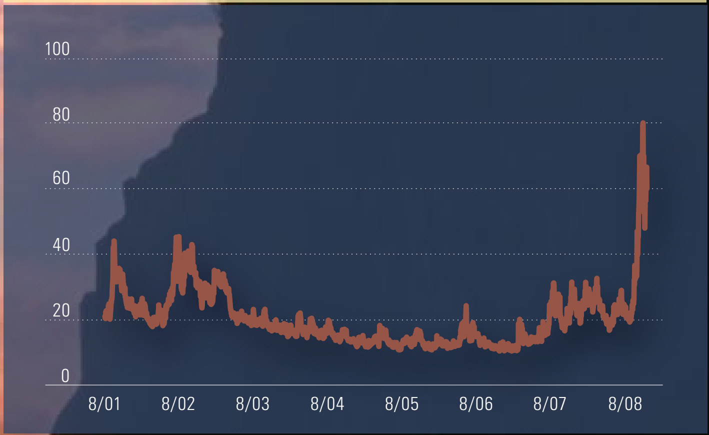
We have recognized that this fundamental shift in market dynamics has created the need to take a fresh look at our enterprise-wide risk management practices. We have completed this task to ensure that, first and foremost, we are able to continuously fulfill our fiduciary responsibilities to our clients and their missions.

The philosophy supporting our risk management framework is based upon the belief that a strong *risk culture*—driven by collective analytical insight, experienced judgment and active collaboration—is the success factor that drives effective risk management. We refer to this *continuous, collaborative risk assessment* as "connecting the dots." This is not designed to be an exercise in trying to predict the unpredictable; instead, it is a process of analyzing and considering all possible outcomes, ensuring that an action plan is aligned to each possible outcome, and moving effectively to mitigate risk rapidly as new or unexpected developments arise. Again, this is a continuous, ongoing process. If the unexpected does occur, we incorporate the breaking news into our process as swiftly as possible, and move our thinking forward to the next decision.

Moreover, the focus of our risk management practice continues to be riveted on servicing and protecting our clients. By building and fostering a risk culture that thrives on open active collaboration, we are confident that risk management will evolve to fulfill the role of strategic risk adviser to our clients and their mission. At the same time, we will continue to provide the combination of consistent long-term risk-adjusted investment returns and superior levels of customer service that meet our clients' expectations, while managing proactively the residual risk of any unexpected surprises under the most challenging circumstances.

In order to create a risk process that allows one to effectively connect the dots, it is necessary to collaborate across all areas—investments, client service, finance, operations, legal, compliance and human resources—to define and prioritize the key elements required within the risk management function. These findings, viewed through the lens of our clients, are summarized in the following pages.

The VIX vaults
8/1/2001–11/13/2008



The Volatility Index, or VIX, is a measure of the expected movement in the S&P 500 Index over the next 30-day period on an annualized basis. Sometimes referred to as "the fear index," the VIX soared to a record intraday high of 80.06 on October 27, 2008—against an average value of 19.04 between 1990 and 2008—meaning investors expected an annual change in the S&P 500 of more than 80 percent. The VIX reflects investors' fear of volatility both ways—up as well as down.

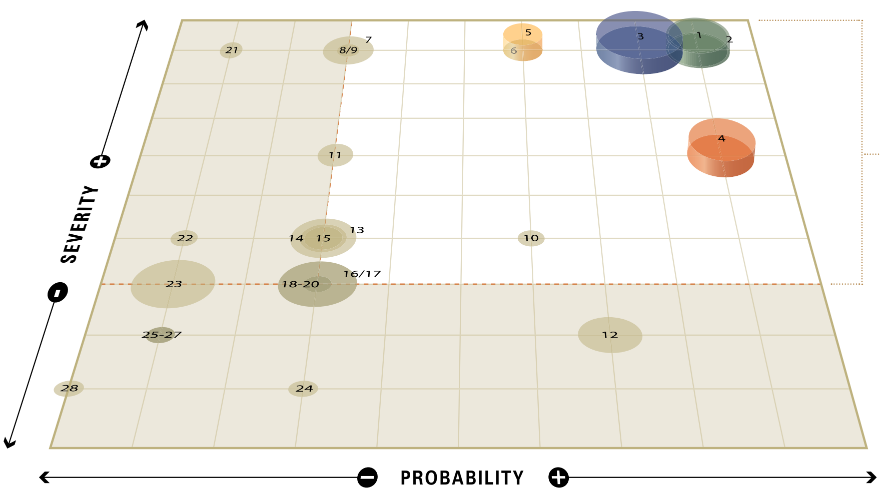
Source: *Chicago Board Options Exchange*

Comprehensive risk management

The critical first step for any nonprofit institution in creating the ability to effectively connect the dots is ensuring that the risk management process is dynamic, forward-looking and comprehensive in its coverage of potential sources of financial harm, reputational damage, litigation or operational failure. Within any risk management framework, the following risk factors will be present. It is important to note that there is overlap and seepage between and across risk factors, and that none of the factors should be treated as isolated or independent.

- *Strategic risk* A forward-looking, top-down stress/scenario assessment of the potential impact to the organization's long-term strategy and investment policy due to fundamental shifts in external factors. *Example of strategic risk:* Market turmoil and continued uncertainty lead to a reassessment of spending policies and systemic change in investment policies of nonprofit organizations.
- *Investment risk* This risk factor covers all aspects of market risk as well as the returns associated with any investment. Moreover, while bank-oriented risk management focuses on the potential loss distribution (e.g., VaR, or value at risk), investment risk also assesses the potential gain distribution to ensure that any investment opportunity offers the potential for a consistent, risk-adjusted return over time. In statistical terms, we assess both tails of the distribution of potential returns and seek to capture moments of unexpected volatility. The risk process then works to understand the drivers of unexpected volatility and ensure that these factors are attributable to intended risk. Any unintended risk is mitigated. *Example of investment risk:* Portfolio diversification strategies do not perform as expected, resulting in unexpected volatility driven by highly correlated asset class performance.
- *Liquidity risk* It is important that liquidity needs, from both an organizational and investment perspective, are understood and considered fully when setting both business strategy and investment strategy. In order to accrue the full benefit of managing perpetual pools of assets to create intergenerational equity, long-term investments must be able to play out. Any need for short-term liquidity, including a budget for the unexpected, must be assessed fully within the longer-term strategy and annual business planning cycle. *Example of liquidity risk:* Limited access to liquid assets due to inability to sell assets at prices reflecting expected terminal value resulting from a reduction in the number of market-makers and reduced risk appetite of banks and investment managers.
- *Balance sheet risk* As with investment risk and liquidity risk, it is necessary to consider all potential risk implications of other activities that would hit the organization's balance sheet, be it short- to intermediate-term financing, swaps transactions to manage interest rate exposure, swaps to manage currency exposure and other structured products. *Example of balance sheet risk:* Market dislocations result in increased levels of basis risk between debt issuance and related interest rate swap hedges.

IDENTIFYING AND PRIORITIZING KEY RISKS



HIGH PRIORITY AREAS: HIGH PROBABILITY AND HIGH SEVERITY

THEME	TYPE OF RISK	EXAMPLE
1 Execution	Financial/ Opportunity	Counterparty risk management—Focus on credit health and daily collateral movement minimizes potential loss
2 Risk Culture/ Best Practice	Financial/ Opportunity	Private equity risk management—Leveraging our knowledge and contacts in the market to determine best risk practice
3 Decision Rights	Financial/ Opportunity	Alternate views of risk—Uncover hidden risks and determine implications of the assumptions made; Focus on scenario analysis
4 Execution	Poor Customer Service/Client Leaves	Intraorganizational communication—Internal communication channels enable us to "connect the dots" and ensure that the client receives one consistent, fact-based message
5 Execution	Reputational	Due diligence—A focus on clear, fact-based due diligence review process, combined with a qualitative assessment of the manager's controls

EXECUTION AND **RISK CULTURE** EMERGED AS THE TWO CRITICAL AREAS OF PRIORITY.

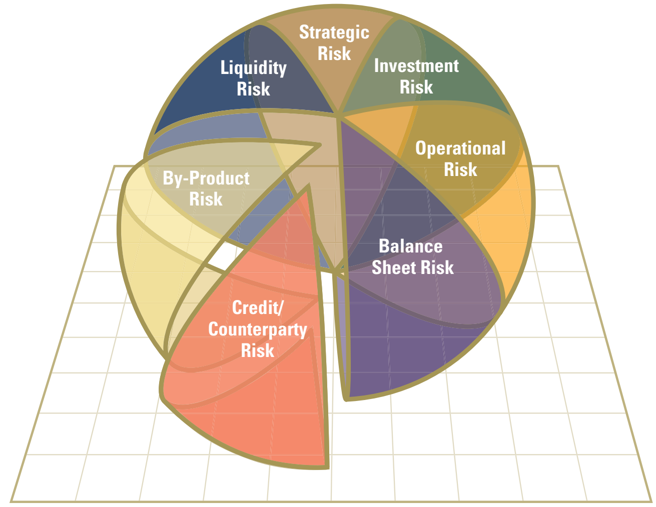
In order to create a risk process that allows us to effectively connect the dots, we have collaborated across all areas of the organization to define and prioritize the key elements of risk management. All risks are not created equal, so ranking the severity and probability of risks is important. The ranking was based, in part, on interviews with clients to understand their risk concerns.

- *Credit/counterparty risk* Today, more than ever, it is essential to employ a market-based methodology of assessing the creditworthiness of one's trading counterparties—looking at long- and short-term ratings, downgrades, bond credit spreads, credit default swaps, credit spreads and equity trading indicators—and to have in place a robust process for collateral management. *Example of credit/counterparty risk:* Instability of financial intermediaries leads to the need to reengineer the collateral management process from monthly settlement to daily settlement (also see operational risk).
- *Operational risk* In addition to the strategic and financial risks described above, it is equally important for organizations to have the ability to assess the risk of loss resulting from human error or failed internal processes or systems, or from external events. *Example of operational risk:* An organization's collateral management process is challenged as price volatility requires daily movement of collateral, processed via third-party managers.
- *By-product risk* This is the risk that arises through the interplay of the risk types described above and the need for active risk mitigation. Recently, crisis management has become an important by-product of the risk management process as the ability to respond effectively to unexpected events is critical. Another example is the need for effective collaboration across diverse functional areas. *Example of by-product risk:* Spiraling market events result in an environment requiring crisis management initiatives focused on resolving unexpected events while continuing to work to deliver to clients' standards.

We have translated all of these risks into a "risk waterfall" that seeks to incorporate these factors into a cohesive methodology that links longer-term policy with routine processes (see page 15).

During our collaborative process of defining the priorities for our strengthened risk management process, one overriding quality was defined as a necessary requirement for our risk managers. Specifically, they needed to have the strength of character to be independent and to be able to present an objective, dispassionate view on any subject that required a risk assessment. This is particularly true when risk management challenges a business decision or the status quo. In turn, this sets the requirement for the independent risk management team collectively to possess a wide range of experience across investments (equities, fixed income, commodities, private equity, hedge funds, real estate, banking, trading, derivatives and structured products), risk types (strategic, market, credit and operational) as well as the technology infrastructure to support the collection and sharing of analysis and information in a user-friendly manner.

THE 360° PERSPECTIVE



Looking at risk management from a 360 degree perspective reveals that risk factors should not be treated as isolated or independent. There should be overlap in each of the areas highlighted in this chart. To ensure overlap—i.e., connect the dots—the risk management process should be dynamic, forward-looking and comprehensive in its coverage of potential sources of financial harm, reputational damage, litigation or operational failure.

The need for experienced and independent risk managers has been made clear during the last 18 months as the validity of statistical risk methods was called into question and the risk process depended more on judgment, common sense and the ability to get things done.

360 degree perspective

Consistent with the theme of connecting the dots, a firm-wide effort to enhance our risk processes highlighted the consensus that, many times, it is the risk management team that is uniquely positioned to view the entire firm, or the aggregate investment portfolio, from a 360 degree perspective. Indeed, the investment portfolio example offers an interesting case study.

We believe that our investment teams employ deep expertise within each of their functional areas, including equities, fixed income, commodities, marketable alternatives, real estate and private capital. Moreover, it is critically important that we preserve the integrity of the investment process, with full authority for investment decisions residing within investment management.

In viewing the investment portfolio in aggregate, the risk management team is positioned to independently assess the risk/return characteristics of the portfolio, either ex ante or ex post, and provide meaningful feedback to the investment teams if actual performance results in unexpected volatility of investment performance. This feedback loop to the investment teams provides a quality control "wrap" on their aggregate portfolio construction activity, while maintaining the integrity of the investment process.

In many ways, the 360 degree view mirrors the perspective of our clients' investment committees and provides a complement to their market assessment.

Capturing unexpected volatility

The process of capturing unexpected volatility continues to prove effective in identifying potential shifts in market dynamics and understanding what is driving the volatility. Another way of describing this process is that it is the point at which risk measurement evolves into risk management.

In the past, the responsibilities of many risk managers were focused primarily on calculating risk metrics that would define, with some degree of confidence, the loss potential for a security, a fund and/or a portfolio. In many instances, this mathematical exercise would be based on an assumption of statistical normality. But, what if the actual performance is inconsistent with our forecast? What if our risk measures are wrong?

The process of capturing and analyzing unexpected volatility acknowledges that markets can behave, at times, in an abnormal manner. While we do not manage to the worst-case scenario or to an eight standard deviation event, we are responsible for knowing when actual results differ from our forecast and what is driving this event.

Moreover, the process of capturing unexpected volatility does not focus solely on the downside, or the potential for loss. Many times, an indicator of potential future losses is the occurrence of outsized gains that are significantly greater than we had expected. Clearly, the role of the risk manager is *not* to prevent our investment managers from realizing gains. Risk managers are responsible for ensuring there is a clear understanding of the components of the outsized gain and that the gains were driven by the intended risk assumed within portfolio construction.

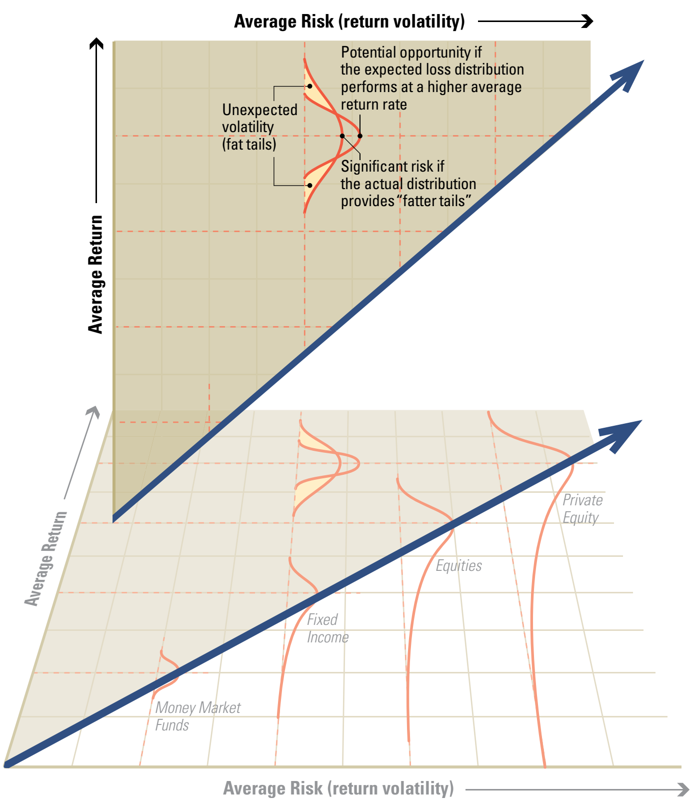
Example: Assume a manager is expected to gain up to 2 percent per month. For the previous month, the portfolio's gain was 8 percent.

Conclusion A: The manager had previously established a position that would benefit significantly from a steep decline in the S&P 500. As the S&P declined during the month, the portfolio benefited.

Conclusion B: Due to quiet market conditions, the manager increased the leverage on the portfolio by 4x. The primary driver of the outsized gain was not the directional investment strategy, but the high multiple of leverage.

The responsibility of the risk manager is then to communicate the conclusion to the investment teams as part of its independent review. The investment teams are responsible for addressing investment activities with the manager. While outsized results do occur from time to time, the drivers of these results, both negative and positive, play a critical role in enhancing our ability to connect the dots.

MANAGING EXPOSURE TO UNEXPECTED VOLATILITY



While the investment teams focus on portfolio construction within each asset class, the risk management team assesses the actual volatility of the aggregate portfolio to its forecasted risk measures. Any event of unexpected volatility, either loss or gain, is assessed by the risk managers to understand the drivers behind the volatility.

Process excellence: due diligence

The collaborative approach described above accepts that risk management is fundamentally a people-dependent process. First and foremost, risk management is about people, the decisions that they make and how well they work together, day-to-day, to execute and deliver value consistently for our clients. Therefore, there is a need to define those processes that are critical to our ability to deliver. We have identified this need for "process excellence" as an integral

For any nonprofit, the key success factor is nurturing a strong risk culture.

part of risk management in order to ensure the teams' ability to execute effectively and efficiently those key processes that will drive performance.

As an example, the due diligence process by which a firm selects its investment managers has been identified as another process that is critical to success. While our existing due diligence process has worked well, we have initiated an exercise to ensure that we continue to work to best practice standards in our assessment of managers. Interestingly, it is important to distinguish managers by their respective markets and design a process that is "fit for purpose" (or, as the English say, "horses for courses"). The following are short examples of how we are approaching due diligence in different markets:

- *Equities* Our current due diligence process is highly detailed, and includes an independent risk assessment performed by risk management. Importantly, our equity managers provide security level details of their holdings. As such, there is a detailed risk assessment of their investment activity, with a high degree of oversight by the equity team with the goal that investment activity remains consistent with investment objectives. In this case, our current risk practice is focused on the front-end decision of hiring a manager.
- *Private capital* As the private capital markets are less transparent and have very long investment horizons, it is challenging to design a risk framework that contributes positively to our effort to define best risk practices within the private capital markets. As part of our approach to private capital, we have defined a short list of private capital managers whom we consider to be "best of breed" and we have begun interviewing each of them to understand their individual approach to risk management. This exercise in collaboration will enable us to clarify how we think risk management is/can be employed most effectively within the private capital markets. We are currently developing a white paper that leverages our learning by addressing the topic "Best Risk Practices in Private Capital."
- *Marketable alternatives* We are constantly challenged by the lack of transparency in the hedge fund market. It is in this market that we have defined an opportunity to strengthen our risk management processes both for selecting new managers and for monitoring ongoing investment activity and performance of these managers. This exercise, in particular, is one that can be described as connecting the dots, as our objective is to increase our ability to view all information relating to a single manager, or all managers investing in the same discipline, easily and quickly. Moreover, the enhanced process will allow us to more effectively provide a comprehensive, qualitative, judgmental risk assessment of a manager, while having easy access to the best available quantitative information.

Risk management should be dynamic, forward-looking and comprehensive.

In order to be able to connect the dots, we need access to a technology infrastructure that will allow us to pull together information and form it easily into a complete picture. Our approach to sharing information is more aligned to Google than it is to more traditional approaches to systems development. As a result, we are already accruing the benefits of our efforts as, every day, we are enhancing our ability to connect the dots. At Commonfund, for example, we are creating an internal risk management portal with a wide range of tools and information that may be accessed not only by the risk management and investment teams, but also by staff in all support functions.

Managing risk in an unpredictable world

How is it possible to manage risk effectively in a financial world that is becoming more and more unpredictable? At the end of the day, is it really worth it? Today, these questions are reasonable, whether asked by a risk management skeptic or by a true believer. These are the very questions that we have asked ourselves.

One answer is to design a risk management framework that is able to respond expeditiously to events, even those that were not foreseen or when the risk is compounded daily. The key elements that drive the effective and proactive management of risk for any nonprofit organization fall into two dimensions:

- *Action* All staff members are able to act with confidence if they are supported by:
  - Accurate, timely data
  - Information flow that gets the right analysis to the right person at the right time
  - Decision rights that clarify decision-making authority while eliminating unnecessary steps or inefficient processes
  - An ability to execute that focuses on minimizing errors and providing feedback on actions taken
- *Discipline* Risk management provides a quality control mechanism that seeks to bring a higher level of consistency and predictability to the way that a firm operates during periods of acute uncertainty. Our discipline is driven by:
  - A strong, firm-wide risk culture
  - A risk management team that, in collaboration with our investment and client service teams, provides an independent view of issues from a comprehensive, 360 degree perspective

Summary

Our world today has created an environment in which the viability of risk management and the risk manager will be tested and challenged. We view this market environment as an opportunity to deliver an advantage to our clients and for our clients to leverage risk management best practices themselves. Again, the starting point of building a robust risk culture is to support the continuous, collaborative process of connecting the dots.

Most importantly, we believe that the risk management process described in this article can be effectively implemented within any nonprofit institution, regardless of mission, size or complexity. The key success factor is to nurture a strong risk culture. This can be accomplished by:

- Bringing a cross-functional team together to define the risk management priorities of your organization
- Educating all of the people involved in the relevant aspects of risk management
- Identifying moments of unexpected volatility, whether it is through investment performance, financial performance or operational performance, and understanding the drivers of volatility
- Fostering an environment that supports collaboration and open dialogue
- Mitigating any unintended risks

It is the human factor that, ultimately, will distinguish a risk management practice. In this approach, the qualitative, or softer, aspects are combined with the quantitative aspects to identify, analyze and mitigate risk. We believe that in risk management sometimes the softer things are the harder things.

If we can be of any assistance to you wherever you are in your efforts to evolve your risk management practice, please feel free to contact anyone from Commonfund's risk management team for advice, guidance or to share experiences. |

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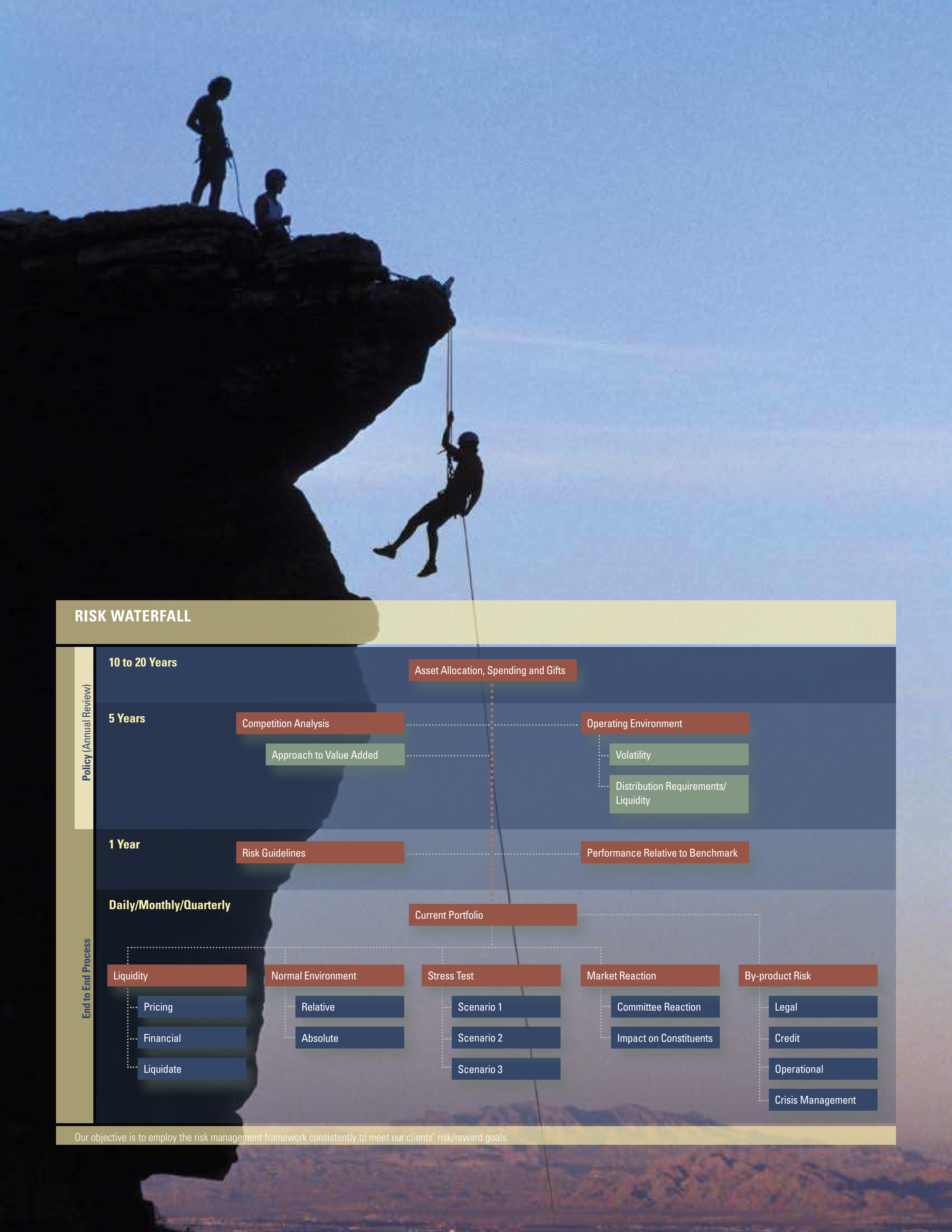


RISK WATERFALL

Policy (Annual Review)

10 to 20 Years
- Asset Allocation, Spending and Gifts

5 Years
- Competition Analysis
  - Approach to Value Added
- Operating Environment
  - Volatility
  - Distribution Requirements/ Liquidity

End to End Process

1 Year
- Risk Guidelines
- Performance Relative to Benchmark

Daily/Monthly/Quarterly
- Current Portfolio
  - Liquidity
    - Pricing
    - Financial
    - Liquidate
  - Normal Environment
    - Relative
    - Absolute
  - Stress Test
    - Scenario 1
    - Scenario 2
    - Scenario 3
  - Market Reaction
    - Committee Reaction
    - Impact on Constituents
  - By-product Risk
    - Legal
    - Credit
    - Operational
    - Crisis Management

Our objective is to employ the risk management framework consistently to meet our clients' risk/reward goals.

Anatomy of **a bubble**

Dissecting the credit cycle:

Hyman Minsky was right

by Lyn Hutton, CIO, Commonfund

So how did we get here—in the midst of a global financial and economic crisis while battling the fallout from the bursting of a credit bubble of historic proportions? We have no doubt that this question will be studied and analyzed by scholars, economists and market pundits of every stripe in coming years—numerous articles, monographs and books will be written about this first decade of the 21st century.

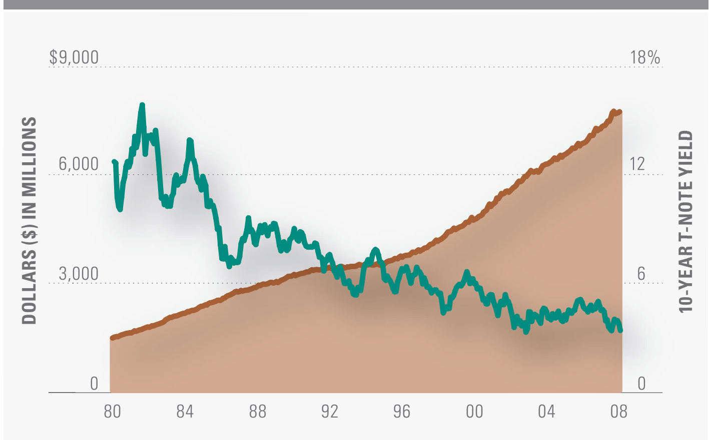
As observed by RAND Corporation Senior Economic Adviser Charles Wolf, Jr., "Those who don't study the past will repeat its errors. Those who do study it will find other ways to err."

While it seems somewhat presumptuous—and early—to draw any conclusions about lessons to be learned from the current crisis, one observation that we would make is that a primary source of bubbles or dislocations in the capital markets is excess liquidity. What is excess liquidity? It is the amount of "money," broadly defined, in excess of that necessary to fund and support economic growth. As we learned in Econ 101: MV= PQ. That is, for economies to be in equilibrium, the amount of money supplied (M) times the velocity (V) of money through the economy should equal the quantity of goods and services produced (Q) times the price of those goods and services (P). In general monetary policy, the amount of money (M) and the cost of money (interest rates or V) are the variables that drive the quantity of goods and services produced (Q) and the price of those same goods and services (P). Too much of M and/or V and the risk of asset bubbles and/or general price instability in goods and services—inflation or deflation—increases substantially. Neither is good for long-term investors.

As illustrated in the chart entitled "Liquidity/Money Supply," M2, a broad measure of the supply of money in the U.S., has increased five times over the 28 years since 1980. However, U.S. GDP has not increased five-fold over that same period. At the same time, the cost of money—interest rates—has steadily declined.

LIQUIDITY/MONEY SUPPLY

1980–2008



M2 10-Year T-Note

M2 in the U.S. has increased five-fold over the 28 years since 1980—expanding at a far faster rate than the economy. At the same time, yields on 10-year Treasuries have fallen in an era of cheap money.

Source: Federal Reserve Bank

This phenomenon of "excess liquidity" has not been confined to the U.S. Both emerging and developed economies have experienced growth in money supply in excess of that needed to sustain real economic growth. For example, in the 1990s Japan sought to flood its economy with excess liquidity to stave off deflation. Every time there has been an economic crisis in recent years, central banks have flooded markets with more liquidity to solve the problem: through the 1997–98 Asian Crisis, the 1998 Russian debt default crisis, the collapse of Long-Term Capital Management in the same year, the bursting of the dot-com bubble in 2000 and in the wake of 9/11 in 2001.

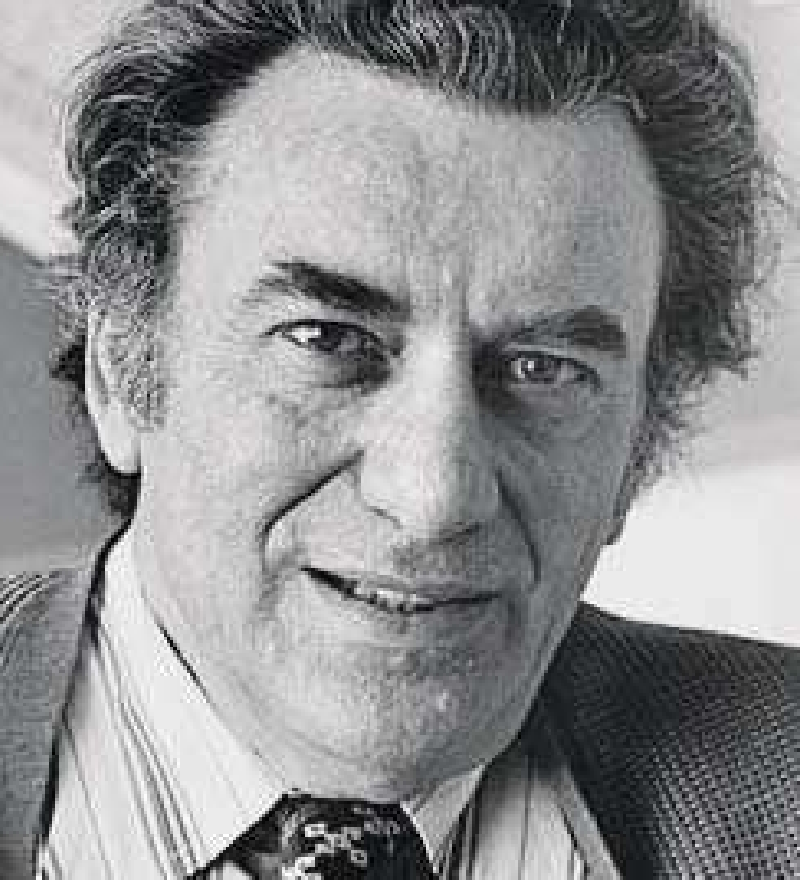
There is a cost of money—of financial capital—and investors should be compensated for supplying that capital or liquidity to the markets. Moreover, the longer the time period until capital is expected to be returned, and the greater the uncertainty over the present value of the capital that will be returned, the greater the risk; investors should demand a higher expected rate of return to compensate for that risk. Still, it is very hard to earn a return on invested capital commensurate with risk when capital is plentiful, i.e., when money is cheap. An excess supply of capital reduces the risk premium to be earned and risk becomes mis-priced. This was the environment in 2006. The capital markets were flooded with money. You could not pick up a newspaper without reading about a "tsunami of capital" or capital markets "awash in liquidity." There was plenty of money—to lend for the purchase of cars and homes; for corporate mergers, acquisitions and buyouts; to construct shopping malls, office buildings and condominiums; and to finance strong economic growth around the world. Economists wrote about "the Goldilocks economy." Euphoria reigned—until one day it didn't.

Understanding the "Minsky moment"

In the 1960s the economist Hyman Minsky posited the five stages of a credit cycle.

Minsky labeled the first stage "displacement," which he described as an abrupt change in economic policy and/or financial regulation. This, he wrote, is followed by a "boom," in which the displacement or change in economic policy takes hold, times are good, investors take on more risk and risk gets mis-priced. The boom period leads to the third stage or "euphoria." Excesses emerge in the economy and the capital markets, often under the guise of "financial innovation." Next comes what Minsky called the "profit taking" stage. Owing to some triggering event—recognition of a slowing economy, for example—some market participants move to realize gains and re-price risk. Then, in the final stage, a panic sets in—everyone rushes for the exit at the same time as investors and bankers again become risk averse and hoard cash. It is during this final stage that we arrive at what is now labeled as the "Minsky moment" when, to stop the damage and bring stability, there is again a substantive change in economic policy or regulatory intervention—bringing us full cycle back to the first stage—displacement.

Hyman Minsky got it right in our view. These five stages pretty much sum up what we have experienced over the last five years. The first displacement was a Fed funds rate of 1 percent from January 2003 to June 2004—the climax of a protracted period of interest



Hyman Minsky (1919–1996), an economist and professor of economics at Washington University in St. Louis, has been widely recognized for research into the characteristics of financial crises.

rate reductions that began in January 2001 as the Fed fought economic recession, the fallout from the bursting of the tech bubble and the impact of 9/11. A 1 percent Fed funds target rate was considered an emergency rate—the lowest in U.S. history. It was a fundamental and major shift in economic policy—the displacement. As other central banks around the world took similar actions, and those policy shifts proved effective, we entered a period of global economic and capital market prosperity.

In June 2004, when the Fed started raising rates, there was a belief that if the Fed was raising rates the emergency must be over. We entered the "boom" phase as economic growth returned, accelerated and there was abundant liquidity. Money was cheap. It wasn't long before the boom turned to euphoria. The pot of capital available to fund corporate mergers, acquisitions, leveraged buyouts, recapitalizations and stock repurchases seemed bottomless. Consumers were able to buy homes with no money down and no income; they were able to finance their automobiles over five, and in some cases, six years; and they were able to extend their credit card lines. The increased demand in housing pushed prices still higher. Equities rocketed ahead, increasing the wealth effect. People furnished and refinanced their homes and, in a burst of financial innovation, these home equity loans were securitized, tranched, divided, split and sold and re-sold over and over again. We saw forms of securities that we had never seen before—CDOs, CLOs, sub-prime, Alt A, option ARMS, no covenant or "covenant lite" loans, credit default swaps and all manner of derivatives. It was the largest credit bubble ever—fueled with excess liquidity and without thought to risk. In this euphoria, we forgot that consumers and businesses don't always repay their debts; that not all mergers are successful; that earnings don't always grow at faster rates; that homes don't always appreciate; that trees don't grow to the sky; that economies sometimes slow down; and, that there is a business cycle after all.

Stresses begin to emerge

In February 2007, the first signs of stress in the housing market emerged. Some investors began to question the credit quality of mortgages and the value of the homes securing those mortgages. Investors realized that some of these financially creative instruments had interest rate resets that some borrowers might not be able to afford and, consequently, there might be some defaults. In addition, the substantial increases in energy and commodity prices began to slow economic growth and reduce corporate profits. The realization started to set in that some bears were coming out of hibernation and hunting down Goldilocks. Earnings announcements from the financial sector were disappointing and many began questioning the quality and valuation of bank and insurance company assets. Selling began. Then, in July 2007, Bear Stearns closed two of its large hedge funds and the managers engineering a few large buyouts couldn't sell the high yield bonds necessary to complete the deal. Selling increased, volatility spiked to record levels and the funding markets froze. Along the way Fannie and Freddie were effectively nationalized and Lehman Brothers filed for bankruptcy. The U.S. bailed out AIG, the world's largest insurer. WaMu was seized and sold off in the largest failure in U.S. banking history. The day after the Lehman failure saw Treasury bills trading with a minus sign, which meant investors were willing to pay the Treasury to hold their money. And so it went, with the equity and corporate bond markets in full panic selling mode during September, October and November.

Now we appear to have reached that "Minsky moment" with dramatic action being taken in Washington and other world capitals. Central banks around the world have mounted a coordinated attack on the global financial crisis. China has pumped $600 billion into its economy and reduced reserve requirements and borrowing rates. The Fed has slashed the Fed funds target rate to 1 percent and it is likely that further reductions will follow. With a $700 billion package, and a promise from the new administration of a massive fiscal stimulus bill, the U.S. government has launched by far its largest intervention in financial markets since the 1930s. And so it starts again: "Those who don't study the past will repeat its errors. Those who do study it will find other ways to err." |

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ASSESSING THE **TRUE COST** OF INVESTMENT MANAGEMENT

What's hidden beneath the surface—like the proverbial iceberg—can hurt you.

by Verne Sedlacek,
President and CEO, Commonfund

When financial executives at nonprofit institutions are surveyed for their most important criteria in selecting asset managers, "fees" are always low on the list. However, when these professionals actually choose a manager or consultant, fees are often a deciding factor.

The reason? Relative certainty. Future investment returns are essentially an unknown. The best one can do is view projected returns from a historical perspective and make an educated guess. But past performance, as has been repeated ad infinitum over the years, may not be indicative of future returns.

Fees, on the other hand, are relatively predictable. One can ostensibly calculate what investment management will cost. At least in theory, costs are accurately projectable.

Investors hope for the best after-cost return, but the only variable of which they can be certain is cost. That said, however, cost may also be one of the most complex variables in the investment business. The fact is, cost can be more difficult to address, understand and calculate than intricate investment concepts such as internal rate of return and value at risk. While the investment industry has developed sophisticated, replicable and auditable ways to calculate returns to compare investment vehicles, there is no comparable cost standard.

The world of fees is changing. Historically, an institution would pay 50 to 100 basis points for traditional, long-only equity management. Today, however, multiple structures exist. Managers of hedge funds or other alternative investments, for example, may charge 2 percent of assets plus 20 percent of profits over zero or a low benchmark.

As investment portfolios have become more complex, so have their cost structures—to the point that calculating the actual cost of a diversified portfolio today can be a herculean task. The complexity of investment portfolios and pervasiveness of incentive fees have made it a real challenge to assess costs and compare providers in any standardized fashion. As a result, few institutions truly understand the cost of their investment management.

A shifting landscape

In a changing investment environment (and especially in a down market) having knowledge of the actual cost of investment management is more important than ever.

In addition, when dispersion of returns is narrow, fees become a more significant factor, often spelling the difference between a top quartile performer and a middle-of-the-pack also-ran. Consider fixed income instruments, for instance. Over the last decade, the difference between a top quartile performer and an average one has been only about 30 basis points per year. Thus, fees are an important competitive differentiator.

The irony is that at a time when it's more difficult than ever to calculate fees, it is also more critical than ever to do so. A perfect storm of three factors illustrates the reasons why:

More rigorous fiduciary standards

The Uniform Prudent Management of Institutional Funds Act (UPMIFA), a law passed in more than 20 states and counting, regulates how endowments and private and public foundations may manage their assets. It demands prudent oversight of the cost of investment management. Section 3(c)(1) of UPMIFA includes a statement that directs an institution to incur only "appropriate and reasonable costs" in managing its investment portfolio. This, of course, raises questions: What, exactly, is the cost? And how do you determine what level of expense is appropriate and reasonable?

Form 990 changes

A second reason that understanding one's costs should be a strategic imperative is the new Form 990, which will become effective in fiscal 2008 (see related article by Tom Hyatt on pages 4–7). The new form extends its reach to the costs of investment management and adds several new classifications of function expenses, including:

- Management
- Lobbying
- Investment services
- Advertising costs
- Office expenses
- IT expenses
- Royalties

Form 990 will soon require answers to multiple questions regarding management fees. Among other queries, it will ask what an institution pays for portfolio management. Those answers must be forthcoming. And since Form 990 is a public document available on the Internet, comparisons of institutions' costs are just a few clicks away.

New federal oversight

The third reason to be aware of one's investment costs is a new federal focus by U.S. Senators Charles Grassley (R-Iowa) and Max Baucus (D-Montana), Chairman of the Senate Finance Committee. They have submitted a questionnaire to 135 of the nation's largest academic institutions, requesting that, among other things, they calculate their annual investment management costs over the last decade.

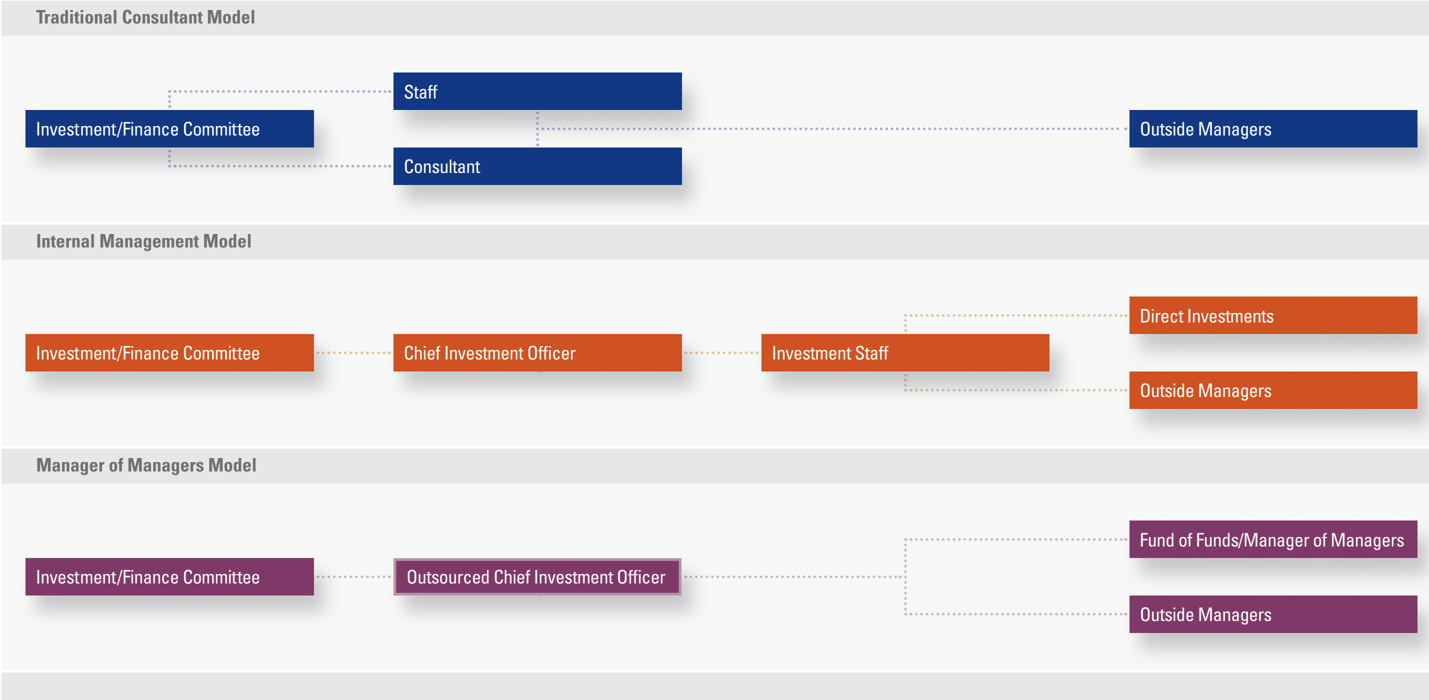
No standard fee calculation method

Unlike standard methodologies to compute portfolio performance, there is no such tried-and-true method to calculate management fees, or to compare institutions' fees to one another. In the 2008 Commonfund Benchmarks Study® *Educational Endowment Report,* 767 educational institutions were asked what it costs to manage their assets. Nearly 25 percent of respondents didn't even venture a guess or chose not to respond.

As investment portfolios have become more complex, so have their cost structures—to the point that calculating the actual cost of a diversified portfolio today can be a herculean task.

UNDERSTANDING COST COMPONENTS

THE TYPES OF COSTS YOU INCUR VARY BASED ON YOUR INVESTMENT MANAGEMENT MODEL



Those institutions that did answer provided a remarkably wide range of responses. Among one cross-section—institutions with endowments of $1 billion or more—estimates of endowment management costs spanned a gamut from 21 to 263 basis points.

What could account for such a wide disparity in reported fees? Certainly, asset allocation is a reasonable hypothesis. (Alternative investment-heavy portfolios would naturally incur higher management fees.) However, among the largest institutions, a comparison of fees reported by the top and bottom quartiles reveals little difference in asset allocation. The most reasonable conclusion, then, is that some reported fees may not include all of the fees incurred for management of the asset pools.

Calculating fees

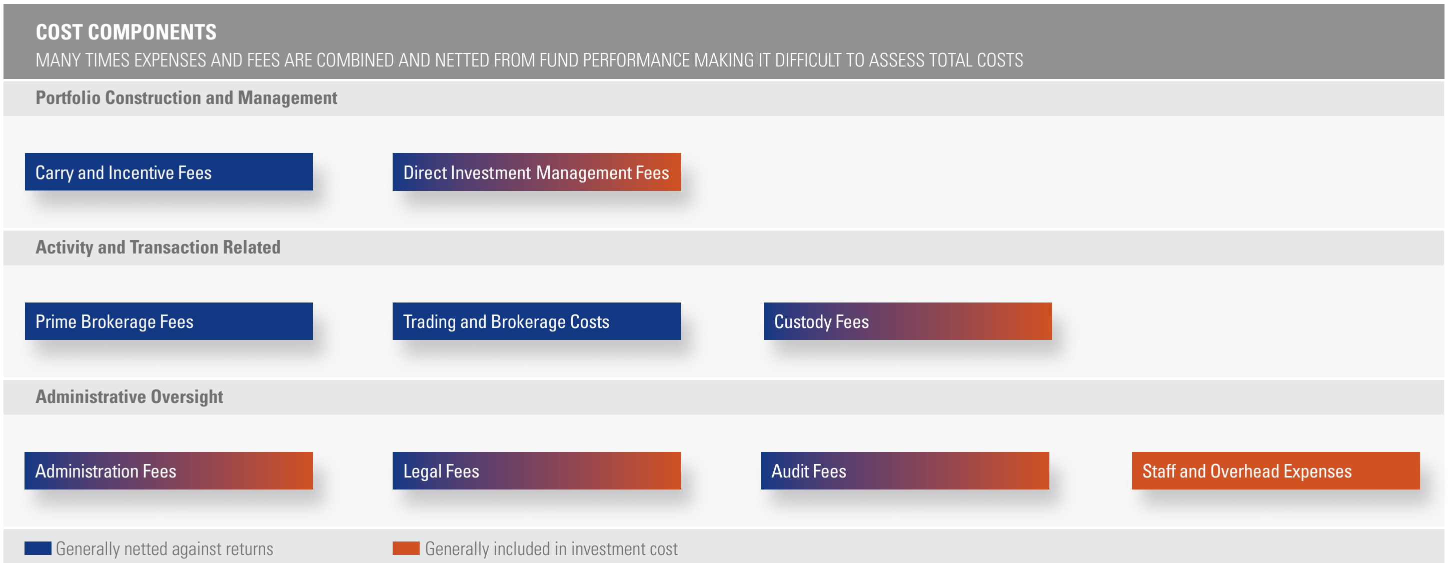
How should one calculate investment management fees? The answer is not readily forthcoming, because the investing environment is no longer simple. Many more variables exist today than did just a few years ago.

One such variable is the structure of asset management. As illustrated in the chart "Understanding Cost Components," endowments, private foundations and healthcare organizations generally adhere to one of three basic models of management. The fee structure of an institution will hinge at least partly on which of these models is in place. The three models are:

- *Traditional consultant* The staff, consultant and investment committee work together to select outside managers.
- *Internal management* An investment staff hires outside managers and may do some direct investing.
- *Manager of managers* An increasingly prevalent model in which an outsourced CIO invests in funds of funds and manages all outside managers.

Another cost variable is an institution's investment strategy, and the resulting asset allocation. Costs will vary depending on the structure of the programs in which one invests. As mentioned, the higher the allocation to alternative investments, the higher the fees—and the more difficult it is to calculate them. If an institution is invested primarily in separate accounts, tallying costs can be as simple as reviewing a monthly invoice and adding custody, consulting and other expenses.

When commingled funds come into play, however, the task becomes more difficult. Expenses may be embedded in the fund. There may be an invoice, there may not. Custody is sometimes built into the fund, sometimes not. Partnerships raise additional issues. One may need to read a heavy document to calculate actual charges in such investments. Mutual funds feature more tightly regulated reporting requirements, but they can be vexing nevertheless. Funds may or may not charge wrap, 12(b)1 and/or other fees.



Three cost categories

Portfolio fees generally fall into one of three basic cost categories:

- Portfolio construction and management
- Activity- and transaction-based fees and costs
- Administrative oversight

Within each of these categories, some costs are charged directly (that is, invoiced) while some are combined and netted from fund performance. This duality can make it difficult to assess actual expenses. All direct and indirect fees must be tallied in order to compute true investment costs.

As indicated in the "Cost Components" chart, red-shaded areas indicate direct charges that are typically included in investment costs—and for which an institution generally receives an invoice.

Blue-shaded areas indicate fees that are embedded in investment performance. Since they are generally netted against returns, they need to be specifically identified or broken out. (Examples include carry and incentive fees, prime brokerage fees, and trading and brokerage costs.) There are also hybrids, such as direct management costs, which can straddle these two areas. Let's examine each of these cost components individually.

Carry and incentive fees

As institutions have continued to invest more heavily in private capital, real estate and marketable alternative strategies, associated carry and incentive fees have increased accordingly. Most managers in this space charge 15 to 20 percent of net profits. Most private equity and venture capital firms charge 20 to 30 percent of profits, sometimes over a benchmark. And most real estate funds charge 20 percent over a hurdle rate.

Direct investment management fees

These can vary widely depending on asset class. An index fund, for example, assesses a modest investment management fee, while actively managed funds are typically more expensive. Emerging markets are more expensive still. As one adds hedge funds, private equity and/or venture capital, and real estate to the portfolio the costs tend to rise considerably.

This variability in asset allocation accounts for a wide range of fees. Long mutual fund management may range from 25 to 100 basis points; private equity may range from 150 to 300; hedge funds, 100 to 200; and private real estate, 150.

For a snapshot of what today's nonprofits are paying in direct investment management fees, refer to the chart "What Others Pay." It illustrates cost outlays for the management of various types of investments among institutions with $1 million to $100 million in assets.

This chart reveals that size matters—up to a point. Larger institutions generally enjoy discounted fees. For example, on average, smaller investors pay 70 basis points for fixed income accounts, while larger investors pay only about 25. A similar disparity can be found in fees for core equity and international equity investments. However, in private capital and hedge funds, the advantage mostly disappears. Because of their limited partnership structure, size does not matter. A $100 million investor and a $1 million investor pay the same 150 or 200 basis points.

It's quite impressive—but, actually, a little distressing—when one considers the number of creative ways that have emerged in recent years for disguising investment management fees.

Custody fees

Custodial fees—safekeeping and transaction costs—are generally regarded as a cost of investment management and added to direct costs, not netted down. However, custodians can be creative, charging minimal basis points for held assets, then assessing high transaction fees.

This is a particularly significant issue in overseas markets, where many sub-custodians charge a transaction fee as a fixed dollar amount, regardless of the transaction size. Thus, the charge is relatively high for small transactions and relatively low for large transactions. These costs are generally 5 to 10 basis points for U.S. funds, 10 to 25 for large international funds and can easily exceed 25 for small international funds.

Prime brokerage fees

Prime brokerage fees, which are usually embedded in hedge fund costs (i.e., securities lending, settlement, clearing, reporting, leverage financing, short covering, etc.), represent potentially the most profitable area for most broker/dealers—which explains why so many brokers have wanted to be in the prime brokerage business. The reason: It is nearly impossible to calculate prime brokerage account fees. One can spend a good deal of time inspecting the costs of transactions, rebates, borrowing, shorts and commissions, yet still come up short of a working understanding of fees or how they are calculated.

Trading and brokerage costs

Trading and brokerage services tend to be covered in transaction costs. But they can nevertheless be difficult to understand because these fees are generally not reported in the total cost of investment management. To be certain, though, they definitely represent a cost. Understanding and monitoring execution costs are critical to minimizing them.

At Commonfund, for example, trading and brokerage costs are largely transparent. They are modest for Treasuries, with bid/ask spreads ranging from half of a 32nd to as high as 3 to 5 basis points for less liquid positions. Asset-backed securities are about 10 basis points, while equities range from 2 to 20 basis points of commission, and +1 to -1 percent in market impact.

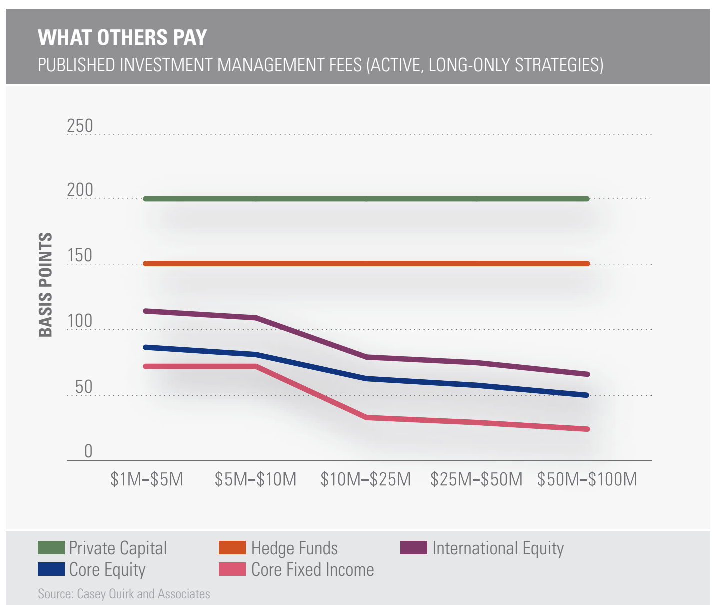
Commissions are fees charged by the intermediary to execute the transaction on exchange trader instruments. For equities, it is usually calculated as cents per share; for futures, it is calculated as dollars per contract.

Market impact is another transaction cost. The act of purchasing or selling a security will move the markets. The larger the transaction or more illiquid the market, the higher the impact.

Commonfund employs an outside service to monitor and minimize trading and brokerage costs. Each quarter, every transaction is forwarded to the service, which submits a report shortly thereafter. This report, which is associated with best execution, examines the actual cost of each transaction by security, manager and fund. Armed with the report, we meet on a quarterly basis with our investment and best execution teams, then discuss the numbers with our asset managers.

Two key areas of focus in these discussions are commissions and market impact. Commission, the per-share costs of each transaction, is a simple calculation. For example, domestic equity is less than 5 basis points and international equities and alternatives are more than 10.

While commissions are a rather easy calculation, market impact —the impact of a decision to execute a trade and the value of that trade—is not. Using a methodology called "weighted average trading volume," the high and low of a day's trading volume are determined, as well as the price and time of execution relative to trading volume.



For many funds, market impact can exceed commission cost. At Commonfund, we work with our managers to reduce market impact cost. But results can vary. An alternative fund manager may be in and out of an investment very quickly, resulting in a sizable market impact. Conversely, long-only managers may tend to build positions or wean off a particular investment over time in order to minimize market impact.

Commonfund also assesses commissions and market impact relative to institutional peers, allowing us to understand the overall cost that money managers pay to execute transactions. Costs above zero represent outperformance relative to a universe of managers; costs below zero represent underperforming that universe. When it comes to costs in international and domestic equities, Commonfund has consistently outperformed the institutional median.

Staff and overhead expenses

Overhead generally refers to internal legal and other staff, technology, reporting, facilities management and so on.

Administration fees

Administrative services, which cover performance, tax and compliance reporting and other fund administration, generally cost 2 to 3 basis points. They are usually bundled with custody and fund accounting fees.

Legal fees

Legal fees are also rising, now accounting for 1 to 3 basis points. Setting up a fund generally incurs $50,000 to $75,000 in startup costs. Separate account set ups range from $10,000 for an on-shore fund to $25,000 for an off-shore fund. And ongoing legal services, which cover document retention, etc., generally incur a $25,000-a-year fee, whether handled internally or externally.

Audit fees

Auditing fees, currently 1 to 7 basis points and climbing, are dependent on a fund's structure, valuation and complexity. The reason they have increased recently relates to the July 2006 pronouncement by the American Institute of Certified Public Accountants (AICPA) regarding the determination and audit of fair market valuation on alternative assets. However, auditors tend to give themselves a good deal of flexibility in terms of fees charged. An institution may negotiate with an auditor, especially if the fund holds sizable assets. But at the end of the day, it seems that—like Canadian Mounties who always get their man—auditors always get their fees.

Oversight touches all cost components

Arching across the aforementioned cost components is the final piece of the puzzle: oversight. To understand how oversight is evaluated and calculated, it is important to first understand the four types of oversight costs:

- *Brokerage wraps* Many brokers—especially those who function as consultants—place an institution's funds with individual money managers. A wrap charge of 50 to 100 basis points is commonly applied for oversight of those managers.
- *Consultant fees* Consultants may charge a retainer fee of $25,000 to $150,000 or more, plus an hourly fee for work performed. In some instances, the hourly fee is credited against the retainer. Hourly fees—which cover such activities as manager searches, reports, phone calls, investment committee visits, etc. —can add up quickly. It should be noted that some consultants have migrated toward another, higher-revenue-producing business model: charging 20 to 60 basis points for providing access to and/or management of investment managers.
- *Independent proprietary management* This office is an internal function that oversees management of individual programs. The cost of this office varies, depending on its staffing requirements, which can range from one to 180 employees.
- *Fund-of-funds structure* This structure applies an overlying fee for selection and management of fund managers, in addition to underlying fees associated with those individual managers. The overlying fee can range from 5 to 200 basis points, depending on asset class. Traditional asset classes generally command 5 to 40 basis points; hedge funds, 50 to 100 basis points plus incentive fees of 5 percent to 10 percent; and private capital, up to 200 basis points plus an incentive.

Key questions to ask

It's quite impressive—but, actually, a little distressing—when one considers the number of creative ways that have emerged in recent years for disguising investment management fees. By way of guidance, there are four key questions to ask an asset manager in order to better understand and more accurately calculate actual fees paid.

What are the specific services being provided, and how are we paying for them?

Be mindful of the "everything's included" promise. At Commonfund, for example, we pride ourselves on forthrightness and transparency. We inform our clients of all management fees. We also identify all client fees at the overlay level, including consultant, investment office, wrap and other portfolio fees.

Be mindful of the "everything's included" promise.

What fees are paid directly, and what expenses are embedded in the net performance of the fund?
Know the types of vehicles in which you are invested. Commingled funds and partnerships, for example, are likely to have hidden expenses. Understand how funds may be aggregated to reach fee breakpoints. Commonfund identifies client fees paid at the fund level—e.g., fund-of-funds fees, direct manager fees and performance fees, which are a cost of investment management.

Avoid a sales pitch that lumps fees based on assets under management or performance-based fees into a blanket fee. By breaking out all fees and understanding them separately, one is better equipped to conduct an accurate, apples-to-apples comparison.

How do you ensure best possible execution of trades to minimize transaction and brokerage costs?
Very few investment managers break out trading and brokerage costs as a subset of direct expenses. It is important to question managers regarding how they strive for the best possible execution in all trading activities. Identify all activity- and transaction-related expenses paid within each investment (or for each manager). These can include not only trading and brokerage, but also prime brokers and custody (net of securities lending, if applicable).

What do you charge in annual commissions or on an average basis?
If it is high, inspect the commission more closely in order to understand constituent activities that are required for administrative oversight and management of the portfolio, including auditing, legal, administration, staffing, infrastructure and facilities.

Conclusion: The ground keeps shifting

Investment management is a constantly shifting landscape. And so are its fee structures. For the reasons cited herein, it is important for nonprofit institutions to closely examine and understand the investment management fees they are paying. It takes a good deal of focus and a good deal of time. But it is well worth both investments. And as the regulatory environment progresses, you have no choice but to do the analysis.

Most importantly, if the fees charged are drastically different than those outlined here, you may be looking at the tip of the iceberg.

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Sustainability: a way of life

Sustainability is certainly a popular term these days. A Google search of the word, for example, generates more than 29 million results.

At the University of Wisconsin-River Falls (UWRF), though, sustainability is more than fashionable—it's a way of life. The university is so serious about contributing to a sustainable society that in 2007 it created a "think and do" tank solely dedicated to reaching that goal: the St. Croix Institute for Sustainable Community Development.

The institute's mission statement—"to support and facilitate UWRF in becoming one of the premier venues for deliberation and demonstration of sustainable community development principles"—may be more expansive than any other sustainability-focused mission in North America.

Off the grid by 2012

To advance its mission, UWRF has embarked on a number of programs. One particularly ambitious initiative is to take the campus "off the grid" and achieve 100 percent carbon neutrality by 2012. It's a tall order. UWRF currently uses coal, oil and natural gas to heat, cool and power its campus facilities. Under the "Off the Grid by 2012" program, those fossil fuels are to be completely displaced by alternative, 100 percent renewable energy sources in four years.

According to Dr. Kelly Cain, director of the St. Croix Institute, failure is not an option. "If we can't walk the talk, then we have no credibility in giving sustainability advice to others," he says.

In fact, he adds, the goal of carbon neutrality may be too myopic. "If we look at the data and the trends, our real target should be a carbon-negative system, in which we actually produce *more* energy than we consume. Sustainability is not a choice. As a society, we must now avoid unsustainability. It's the ultimate team sport, and we have to win."

The UWRF team is currently exploring multiple alternative fuel sources. To replace the 4,000 tons of coal required annually to heat campus buildings, the team is exploring biomass fuel—organic pellets made from dead grass, wood and other plant matter. In an effort to eliminate the school's reliance on external sources of electricity, the campus is researching solar arrays over parking lots and commercial wind turbines on an off-campus lab farm, just to name a couple.

In the meantime, UWRF is taking incremental steps toward carbon neutrality. The student body is now 100 percent "green block" in dorms and the University Center, agreeing to pay premium rates for electricity generated from renewable energy sources.

Government backing

The Off the Grid by 2012 program has the full support of the state's government. In fact, in 2006 Wisconsin Governor Jim Doyle specifically targeted the campus for energy self-sufficiency. "UWRF is obviously a natural to be selected for this pilot," the governor said. "This campus has been devoted to conservation and renewable energy."

The school has a rich history of supporting sustainability, both on campus and in the St. Croix Valley, where it is located. For example, its new $35 million student center is a model of energy efficiency, including natural building materials as well as a 48,000-gallon rain water storage tank that is used for flush water.

In addition, the school works with local and state leaders and public partners to help them reduce their communities' carbon footprints. Among the priorities are downtown revitalization, self-sufficient energy and food systems, and potable water conservation.

According to Cain, UWRF's Off the Grid by 2012 program is particularly significant for the higher education community. "Off the Grid is just one of the ways we must take a leadership role, or risk irrelevance as a public institution. It is a chance to demonstrate that we are part of the solution rather than part of the problem by maximizing ROI to our most important stakeholders, the people of Wisconsin."

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The new student center at the University of Wisconsin-River Falls is highly energy efficient.

Rethinking asset allocation

Have the basic concepts of diversification changed?

by Verne Sedlacek, President and CEO, Commonfund

Should we begin thinking a little differently about asset allocation? It's a timely question because over the course of the last 30 years the concept of asset allocation has changed.

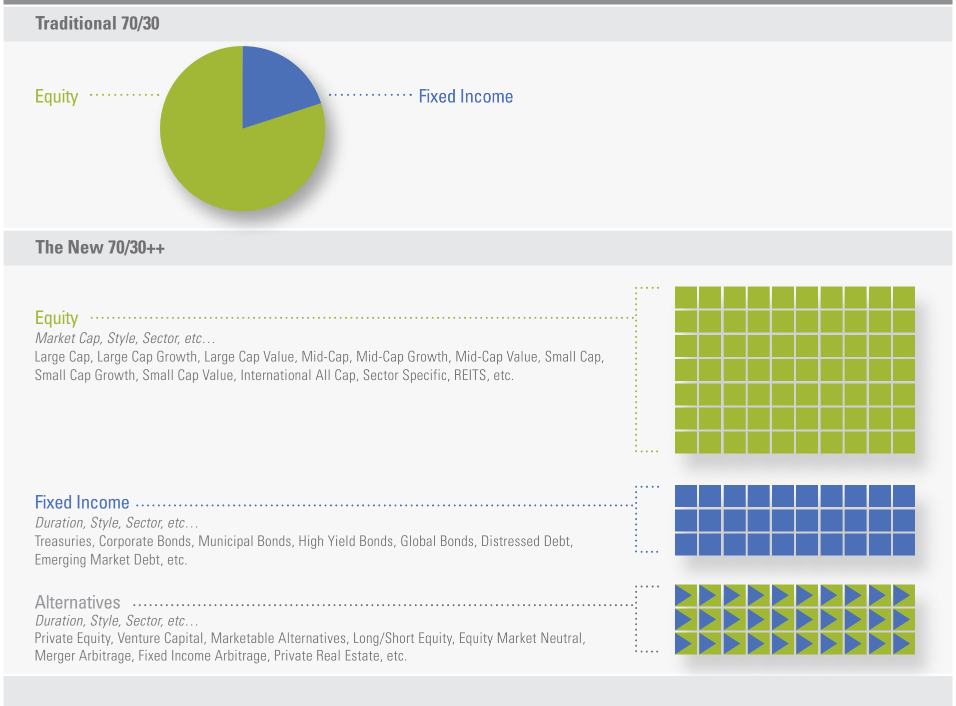
Think back to the late 1960s when the academic work on diversification was first published and promulgated. It held that if investors built portfolios of uncorrelated assets they would likely secure both higher return and lower volatility. It was a very simple concept and one that was proven through the mathematics of variances, covariances and expected returns. Ultimately, it created the diversification movement of the last few decades.

Now flash forward 40 years and consider whether some of the basic concepts of diversification have changed. First, asset classes that have been diversifiers historically, in fact, have ceased to provide a diversification benefit. Second, we need to consider whether investment committee members or senior financial managers of nonprofit institutions are devoting the correct amount of time to asset allocation. Third, we should consider whether we have taken asset allocation and remade it into risk management. Have we put so much emphasis on asset allocation and policy portfolio concepts that they obfuscate some of the important portfolio risk factors?

Slicing and dicing 65/35

I remember the good old days of asset allocation. When I got to Harvard in 1983, our asset allocation was 65 percent stocks, 35 percent bonds. That was pretty easy to understand. Over the course of the last 25 years we have taken the overall concept of 70/30 or 65/35 and sliced and diced it into many

THE EVOLUTION OF ASSET ALLOCATION



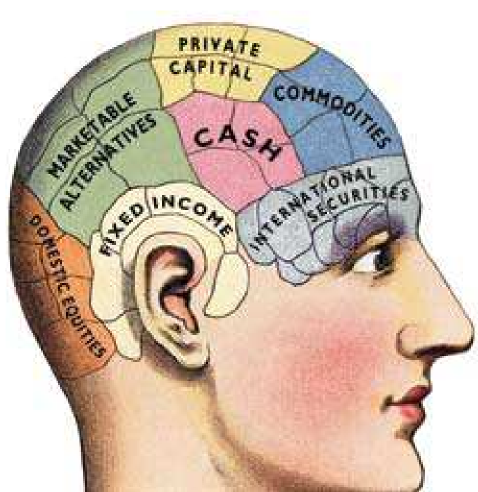
small buckets that we consider to be independent of one another. Thus, as one thinks about the policy portfolio and asset allocation, it's no longer 70/30 equity/fixed. It's now 4 percent invested in small cap, 12 percent invested in growth, 8 percent invested in value, 5 percent venture capital, 8 percent international and so on. We continue to parse our asset allocation into smaller and smaller buckets, and as a result there is a tendency to spend a lot of time thinking about how we allocate between mid-cap growth and mid-cap value, or how we allocate between small cap and large cap.

The question I ask is, Does spending a lot of time thinking about asset allocation across highly correlated asset classes really make a long-term difference? And, even as we get into newer alternatives—that is, the diversifying concepts of hedge funds, private capital and commodities—have we parsed it to a level where we're spending a lot of time discussing things that may not actually make a long-term difference?

Go back to the original premise: Diversification works if the portfolio is built on assets that are uncorrelated to one another. But, lately, we're seeing asset classes converge. Capital markets have become increasingly integrated around the world. The speed and violence with which global markets react to one another has been truly astounding.

Thinking differently about asset allocation

Over the years, we have utilized the concept of asset allocation to address several additional concepts that go beyond asset classes. For instance, do we create separate asset classes for public and private equities—not because they are uncorrelated but because one is liquid and one is illiquid?



Perhaps we really do have to think about asset allocation a little bit differently. Instead of thinking about one master asset allocation that covers everything from cash to private equity and venture capital, perhaps we should think about multiple allocations associated with evaluating our portfolios and make independent decisions relative to these four layers:

- Assets
- Liquidity
- Currency
- Risk

The asset *layer* concept reframes thinking about how you allocate your assets to create a diversified portfolio. We expend significant effort to evaluate allocations to "asset classes" that are correlated, for instance, public versus private equity, U.S. versus developed market equities, U.S. Treasury bonds versus non-U.S. government bonds (ex-currency). In today's environment many of those so-called asset classes have become more correlated. Asset allocation work should focus on those asset classes that are truly unrelated. These are equity, fixed income, absolute return strategies and real assets. Each of the current asset classes in the first layer would fit within one of these four "super asset classes."

The second layer focuses on how you allocate your assets to take advantage of your ability to invest in illiquid instruments. You can invest in alternatives that are liquid and you can invest in equities that are illiquid. Here again if you want to look at your allocation to various types of illiquidity you should do this separately. This liquidity risk spans the asset classes and should be specifically broken down. In each of the super classes there will be liquid assets (like U.S. and developed markets equities) and illiquid assets like distressed debt and natural resources.

The third layer is currency. It's easy to become confused about currency. We say we want to allocate to international equities, but, in reality, there are two components to that—international equity and currency. With

Convergence of managers' strategies

As we look at what is happening with managers, particularly as we move into the hedge fund space, we are seeing a convergence—for instance, activist hedge funds that may invest in public stocks but look to make material changes in the way portfolio companies are managed, thus acting like private equity managers. We see hedge funds that invest in private capital and distressed debt.

As an industry, we need to think about whether we are limiting managers by putting tighter and tighter constraints around each of these asset classes and, in the process, limiting investment managers' ability to make money. It's an important question we as an industry have to ask ourselves. In the days of 70/30 you could focus on the areas where you were going to add value. Now, as we parse our managers into smaller and smaller categories, we have to wonder if we are reducing their ability to take advantage of opportunities as they present themselves.

As for today's environment, it may be a wonderful opportunity. Because as long-term investors, nonprofits can put their liquidity to work to buy assets that are cheap. I was talking with a foundation about Warren Buffett. Is he a liquid asset manager or is he an illiquid asset manager? I would say he's an illiquid asset manager who exercises some of his allocations through the liquid markets. We saw that recently in his investments in Goldman Sachs and GE. Assets are tremendously cheap—but only if, like Warren Buffett, we have the ability to buy them. That's the value of asset allocation—it helps us to reallocate to those assets that are relatively cheap.

today's instruments you can manage those independently because, for example, when you invest in euro-based equities you don't have to take euro risk. You can hedge that or, vice versa, you can invest in U.S. equities and create euro risk.

The fourth layer is risk. As it relates to risk, investors can determine the profiles of their assets on a number of levels. One method is value at risk (shown in the chart at right). Others include stress testing and examining the total potential loss under various scenarios. These data can then be accumulated to show total risk as well as risk by various components based on differing asset allocations. Execution decisions relate to policy and will generate new types of risk that should be identified and quantified.

Thinking about these four layers conceptually will yield a comprehensive view of your portfolio and allow you to focus on factors that are likely to make a long-term difference in your portfolio, and not get buried in the 17 asset classes that you call your equity portfolio.

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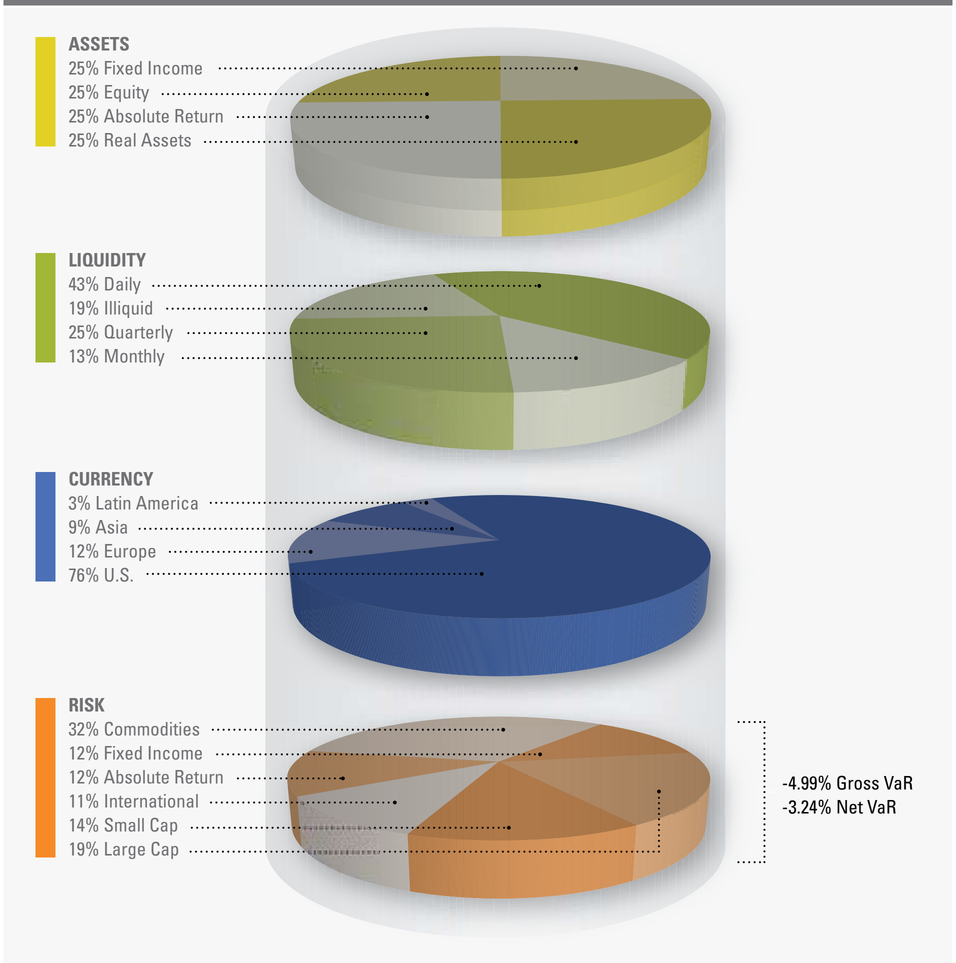
MANAGING MULTIPLE ALLOCATION LAYERS



Focus on what makes a difference—assets, liquidity, currency and risk.

Small can **be big**

How one healthcare organization captures better investment performance

The size of a nonprofit's asset pool frequently correlates with investment performance—the larger the pool the better the performance. But there's no law of nature that dictates that outcome, as one smaller healthcare organization in the Northeast clearly demonstrates.

In the annual Commonfund Benchmarks Study® *Educational Endowment, Foundations* and *Healthcare Organizations Reports,* Benchmarks Leaders are those organizations whose investment returns place them in the top decile or top quartile of all Study participants. Frequently, the top decile and top quartile are dominated by organizations with large endowments or investable asset pools—nonprofits with $1 billion or more to invest or those with assets between $500 million and $1 billion, for instance.

In the most recent (2008) Commonfund Benchmarks Study *Healthcare Organizations Report,* 13 organizations each from the three largest cohorts achieved the top quartile (a total of 39), while just two from the smallest cohort of organizations with assets between $51 and $100 million qualified.

A summary of FY2007 returns by size of investable asset pool as reported in the 2008 Benchmarks Healthcare Organizations Study (see chart below) confirms a consistent

FY2007 INVESTMENT RETURNS
2008 COMMONFUND BENCHMARKS STUDY *HEALTHCARE ORGANIZATIONS REPORT*

All Study Participants	Over $1 Billion	$501 million–$1 billion	$101 million–$500 million	$51 million–$100 million
8.0%	9.1%	7.8%	7.5%	7.3%

Jill Batty, Chief Financial Officer, and Peter Whittemore, chair of the investment committee, outside of CMC/DHK's Court Street campus in Keene, New Hampshire.

size/return correlation. Not only are returns lower for smaller healthcare organizations, so, too, is investment income as a percentage of net income. The median for all Study participants was 48.6 percent. For healthcare organizations with assets between $51 and $100 million, the median investment income as a percentage of net income was just 30.5 percent. The smaller healthcare organizations in the Study also had razor-thin operating margins—negative, in some cases. Thus, the organizations that need better investment performance the most often aren't getting it.

All this raises a question: If two smaller healthcare organizations can achieve top quartile returns, why not more?

Cheshire Medical Center/Dartmouth-Hitchcock Keene—one of the two top quartile healthcare organizations with assets between $51 and $100 million—demonstrates how it has been able to rank among top echelon performers.

While the average return for all participants in the 2008 Healthcare Organizations Study was 8.0 percent, Cheshire Medical Center/Dartmouth-Hitchcock Keene (CMC/DHK*) realized a return of 9.5 percent, which was even ahead of the average 9.1 percent return for Study participants with assets over $1 billion. CMC/DHK outperformed on a longer-term basis as well, posting average annual three-year returns of 9.9 percent versus 9.0 percent for the Study population as a whole and average annual five-year returns of 13.9 percent compared with 11.1 percent for the overall Study group. CMC/DHK's longer-term returns are even more impressive when compared to their peer group. And, while peer organizations in the 2008 Study reported median investment income of 30.5 percent (as a percentage of net income), the comparable CMC/DHK figure was 89 percent.

*CMC/DHK is a participant in the Commonfund Benchmarks Study® *Healthcare Organizations Report*; it is not a client of Commonfund.

Attribution is multi-faceted

There's no silver bullet in the medical center's arsenal. So, to what should the higher returns be attributed? Many factors play a role.

First, though, some background on this healthcare organization: CMC/DHK is located in Keene, a city of about 22,000 in southern New Hampshire. While legally separate organizations, Cheshire and Dartmouth-Hitchcock Keene have a joint operating agreement under which they provide healthcare for the community and combine for expertise, technology and programs. CMC/DHK comprises a 169-bed acute care regional hospital and a 125-provider multi-specialty physician group practice associated with the Dartmouth-Hitchcock health system. The annual operating budget for 2007 was $140 million, and operating margins were in the range of 2 to 3 percent.

Cheshire Medical Center traces its history to 1892, when it was founded as the Elliott Hospital. The Keene Clinic was established in 1948. The medical center moved to its present location on Court Street in Keene in 1974. In 1993, the Keene Clinic became Dartmouth-Hitchcock Keene, and the joint operating agreement, implemented via the Keene Healthcare Alliance, went into effect in 1998.

Cheshire Medical Center is governed by the Cheshire Health Foundation, while the CMC/DHK partnership is governed by an independent body, the Keene Healthcare Alliance. The Cheshire Health Foundation, with a 22-member board, has responsibility for the investable assets.

Currently, a key initiative is Vision 2020, in which CMC/DHK has articulated the ambitious goal of making Keene the healthiest community in the nation by the year 2020. The vision statement holds that success "will be measured by the medical outcomes, the continuity of care for our patients, the overall health of our community and the satisfaction of those we serve."

Chief Financial Officer Jill Batty believes that CMC/DHK is favorably positioned in its market. "Cheshire Medical Center is fortunate to be an independent hospital that has a strong partnership with a well-managed clinic, Dartmouth-Hitchcock Keene, and that makes it possible to function as an independent hospital in today's environment," she says. "The partnership with the clinic is a great physician recruitment tool and we have the benefit of operating in a relatively well-protected environment."

Long-term capital challenges

If there is a concern, it is in the area of long-term capital challenges. "We have an older hospital physical plant and our ongoing information technology requirements are huge," Batty observes. The debt level at year-end 2007 was about $23.7 million, 90 percent of it at fixed rates.

In terms of investment management, the Cheshire Health Foundation is responsible for three asset pools: endowment funds and special purpose funds (held on the hospital balance sheet) totaling some $36.3 million and the defined benefit (DB) pension plan of about $38 million. (All figures are as of December 31, 2007. Returns and other metrics in this article refer to the investable asset pools alone, excluding DB pension plan assets.)

Peter Whittemore, a former banker, is chair of the investment committee. The committee has a total of nine members, including Whittemore, CEO/President Art Nichols, four current trustees, two former trustees and a physician. Among the current trustee members, one also sits on the finance committee and another is on the development committee. Committee members serve three-year terms and by tradition (but not by bylaw) may serve up to three terms.

CMC/DHK's investment committee is intense, but listens and exchanges views.

Unless there is a special need, the committee meets on a quarterly basis, usually late in the month that follows the end of a quarter. Information about performance and other portfolio metrics is distributed in advance of the meeting. Batty says committee members communicate outside the regular meetings as needed. A recent example is restructuring the medical center's pension plan to a 403(b) structure, which required analysis and review by the investment committee and which took place largely outside the framework of regular meetings.

In addition to Batty, staff resources consist of a controller, an assistant controller and three accountant/analysts—a level that Batty recognizes is unusual for an organization of CMC/DHK's size. Investment activities are supported only by Batty and the controller, however. "Because we have an assistant controller, it's possible for the controller to devote time to rebalancing, general accounting issues and getting the audits completed on time," she says.

Development effort gets off the ground

CMC/DHK had virtually no development effort for some time until a development committee was reactivated in 2007. It has received a few substantial gifts, but not as the result of any planned effort. As the development office is still new, Batty says no major campaigns have been launched other than an annual giving campaign to support operations.

Turning to the investment policy—which is developed by the committee and approved by the full board—Batty says that philosophically CMC/DHK seeks high, equity-like returns with reduced volatility. She readily admits, "Of course, that is what everyone wants and we understand that we won't always be on the upside and never on the downside." The other key philosophical underpinning is a long-term orientation. "Committee members and the organization itself are really good about acknowledging long-term objectives as opposed to reacting to short-term ups and downs. The managers with whom we work get a lot of room to make mistakes and recover from them. But, we keep our eye on performance over the long haul and if, over time, it's not happening to our satisfaction, they can expect to be asked to explain why they are where they are and where they think they're going," Batty explains.

Investment objectives identify four primary drivers behind the portfolio:

- *Total return* The board's primary total return objective is to exceed the long-term rate of inflation by 5 percent; a second objective is to provide a satisfactory level of income.
- *Risk* The total fund will be less volatile than the equity market, and the equity portion is expected to have volatility less than the S&P 500 over a long-term horizon.
- *Time horizon* The fund operates with a 10-year investment horizon and has no unusual liquidity needs. (Batty says, "There's a lot of attention paid to any one quarter, but it's never in the absence of understanding the long term.")
- *Asset allocation* The fourth key point addresses asset allocation. The chart below shows the policy, range and actual allocations as of December 31, 2007.

Each of the individual allocations is measured against an appropriate benchmark. The entire portfolio is benchmarked over a three- to five-year market cycle and is measured against a hybrid index made up of the Russell 3000 Index, the MSCI EAFE Index, the HFRI Fund-of-Funds Index and the Lehman Aggregate Bond Index. The overall investment policy is reviewed on an annual basis, unless otherwise recommended by the committee.

All of the allocations have outperformed over one-, three- and five-year periods, except for fixed income, which lags for all periods. Aside from the large cap core allocation, all of the assets are invested through mutual funds and a fund of funds.

Allocations to alternatives and international equities

Batty says the asset allocation has been fairly steady in recent years, except for the move to alternative strategies, which in the CMC/DHK portfolio are entirely represented by a single hedge fund-of-funds allocation. The initial investment in alternatives began in 2003, and has grown modestly since. Batty says that the reason for the go-slow approach to alternatives is regulatory concerns. "We have difficulty filing our Form 5500 because of the amount of time it takes to get the valuations validated," Batty says. "It's partly getting comfortable with alternatives, but also an operational challenge."

2007 ASSET ALLOCATION

Asset Class/Strategy	Policy	Range	Actual
Domestic equities	45%	36–54%	45.8%
Core equity	*30*	*24–36*	*30.8*
Mid-cap growth	*5*	*4–6*	*5.0*
Mid-cap value	*5*	*4–6*	*5.1*
Mid-cap core	*5*	*4–6*	*4.9*
Fixed income	25	20–30	22.0
International equities	20	16–24	22.0
Alternative strategies	10	8–12	10.4

The other change has been an increased allocation to international equities. Both increases were funded, first, by reducing the allocation to large cap equities (the core allocation) and, secondly, by a modest reduction in the fixed income allocation. While marketable alternatives comprise the entire alternative asset allocation at present, the committee is studying an expansion into real estate and commodities, according to Batty.

The largest allocation, to domestic equity, is based on a core allocation and an emphasis on mid-cap core, growth and value. Why the mid-cap focus? Batty says the committee believes mid-cap stocks offer more diversification than large caps and, thus, a greater opportunity for risk reduction. "I don't think anybody on the committee feels like they've got a special insight into the market and so they're more interested in being diversified," says Batty.

The endowment has been contributing about $2.5 million to annual operations, Batty says, but she points out that this transfer of funds from the endowment is focused on community health, community education and the Vision 2020 initiative, and is not used to support the medical center. "We've been working to have the medical center cover its own operating expenses, while using the endowment to take on more of the community-oriented spending," she says, adding, "The foundation has a target of 4.7 percent of average balances being available for annual operating expenditures. It's a guideline, not a strict policy, and $2.5 million is at the high end of that range."

Reading between the lines, what is that special quality that sets CMC/DHK apart? Batty recalls her earlier days in the industry when she worked for two large systems, West Penn Allegheny and the University of Pittsburgh Medical Center, both in the Pittsburgh area. Her early exposure to investment management was at an independent community hospital, Shadyside, which ultimately merged with the University of Pittsburgh Medical Center. "Shadyside had a very active investment committee, and the chair of the hospital's board took a particular interest in investment management. For me, at the time, it was really fascinating because that group pushed for taking more risk. I didn't have anything to do with the decision-making process, but it was just interesting to hear the discussions and arguments. And it paid off well for that organization."

A conducive atmosphere

On coming to CMC/DHK, Batty found much the same atmosphere. "I was pleasantly surprised to find that there was a similar level of interest and intensity, and a willingness to listen and exchange views. This is not a timid group. I wasn't necessarily expecting that when I arrived, but it surely exists."

The fact that CMC/DHK has a zero allocation to cash and short-term securities also boosts returns. Says Batty, "We don't view our operating funds as being available for the investment fund. We focus on investable assets, and consider cash to be undesirable." CMC/DHK typically maintains $7.5 million in operating cash, which it keeps in overnight accounts rather than actively managing it. Batty says cash balances at any one time can be a little higher or lower than might be considered reasonable, but the organization is comfortable with its liquidity level.

In sum, then, there are both tangible and intangible factors that drive this organization's better investment performance. Clearly, CMC/DHK is operationally sound and enjoys a secure position in its served market. Based on equity returns that exceed CMC/DHK's benchmarks over a five-year time period, good stock picking has paid off. Returns for FY2007 also outstripped those of the average participant in the Commonfund Benchmarks Study: CMC/DHK's domestic equity return was 8.2 percent versus an average of 6.3 percent for Study participants generally, and its international equities allocation returned 14.3 percent compared with 12.1 percent for the average Study participant. Compared to its immediate peer group, CMC/DHK's 22.0 percent international equities allocation is well above the average 12 percent allocation of organizations with assets between $51 and $100 million in the 2008 *Healthcare Organizations Report.* However, the 10.4 percent allocation to alternatives is lower than its peer group allocation of 13 percent. And, as it happened, CMC/DHK's alternatives allocation—perhaps because it is concentrated—underperformed the average Benchmarks participant in FY2007, returning 11.9 percent versus 12.8 percent for the Study universe as a whole. The absence of cash is another major factor, especially when compared with peer organizations in the Benchmarks Study, which reported an average allocation of 14 percent to short-term securities and cash.

The less tangible factor is the investment committee's philosophy. It's a group that is willing to take some degree of risk, as long as it is reasonable and mitigated by diversification. The committee is also oriented to the long term. It realizes that any manager's style and strategy can and will underperform at certain times, and it accepts that—but only to the point where it demands a fuller explanation that must meet its satisfaction.

As has been observed a number of times in Commonfund Benchmarks Studies, it is disappointing when regulatory and reporting burdens—especially for smaller nonprofits—get in the way of asset allocation decisions, particularly allocations to alternative strategies. The importance of adequate staff has increased since 2006 when the American Institute of Certified Public Accountants (AICPA) released a set of guidelines concerning the valuation of illiquid investments such as private equity, venture capital and hedge funds. Jill Batty's comments about going slow with regard to a greater alternatives allocation clearly reflect this challenge. |

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Commonfund Institute, NACUBO
partner on joint higher education endowment study

New *NACUBO-Commonfund Study of Endowments* to be the most comprehensive annual survey

Commonfund Institute and the National Association of College and University Business Officers (NACUBO) have announced that they are combining their resources to create a single, comprehensive annual study of higher education endowments beginning in 2009. The current Commonfund Benchmarks Study® *Educational Endowment Report* and *NACUBO Endowment Study* will merge to create the 2009 *NACUBO-Commonfund Study of Endowments* (NCSE) on higher education endowment investment performance, asset allocation and related finance and governance issues. The new report will cover fiscal year 2009 (ending June 30, 2009) and will be released in January 2010.

Currently, there are approximately 800 participating institutions included in each individual study, with about 66 percent of institutions participating in both separate studies. Combining the studies will aid higher education institutions as they will no longer have to respond to separate questionnaires on their endowment results each year. The historical databases of the surveys will be centralized and warehoused for access and use by higher education institutions and scholars.

"We are very excited by our partnership with NACUBO on the 2009 *NACUBO-Commonfund Study of Endowments* and future endowment surveys," says Verne Sedlacek, President and CEO of Commonfund. "This is a historic opportunity for us to pool our resources to produce the industry's most definitive, in-depth annual study on the state of higher education endowments."

Thought leadership

The new study will provide thought leadership from the best minds on endowment management, and will be the single source for institutions to benchmark themselves against their peers to achieve optimum results and support their missions.

John Walda, President and CEO of NACUBO, notes, "NACUBO is proud to partner with Commonfund—a highly respected leader in higher education financial management—to create a broader, more comprehensive analysis of higher education endowments. The *NACUBO-Commonfund Study of Endowments* will not only create a more efficient reporting process for higher education institutions as well as a more precise representation of their nonprofit endowments, but will also be a valuable resource for those who manage higher education financial assets."

The 2009 survey will eliminate areas of overlap that currently exist in the respective Commonfund and NACUBO questionnaires. The new questionnaire will be a combination of qualitative and quantitative information, conducted through an online survey supported by qualitative information gathered through representative telephone interviews. This information will be reported back to the organizations that participate in the study in the form of a written report that can be used to develop industry trends and benchmarks for nonprofit communities.

"Our combined survey will encourage greater participation by higher education institutions, providing a more complete and accurate picture of nonprofit endowments," says John Griswold, Executive Director of Commonfund Institute. "It will foster best practices and

save time and administrative effort by allowing institutions to report endowment results through one online questionnaire, followed by telephone interviews to identify qualitative issues and supporting trends underlying the numbers."

Comprehensive report

The 2009 *NACUBO-Commonfund Study of Endowments* will be divided into sections on various aspects of endowment management:

- General information, including types and size of educational institution, endowment detail, investable assets and market value of component categories
- Returns and asset allocation will focus on investments in domestic equities, fixed income, international equities and alternative strategies as well as portfolio rebalancing
- The chapter on spending will include spending trends, special appropriations, operating budgets and use by colleges and universities of the Higher Education Price Index (HEPI), a measure of annual changes in the price of goods and services most frequently purchased by these institutions
- Gifts and donations, including development program costs and underwater funds
- Debt load, debt policies and institutions' response to the current interest rate environment
- A chapter devoted to resources, management and governance, including investment manager use, cost of managing investment programs, professional staffing, investment committees and how educational institutions are responding to valuation guidelines promulgated by the American Institute of Certified Public Accountants (AICPA)

The new combined study will include institutions with endowments beginning at $1 million and ranging up to $1 billion and more.

NACUBO serves a membership of more than 2,500 colleges, universities and higher education service providers across the country. NACUBO represents chief administrative and financial officers through a collaboration of knowledge and professional development advocacy, and community. Its vision is to define excellence in higher education business and financial management. NACUBO has conducted its study among endowments for 30 years. For the past decade, the survey has been conducted online.

Commonfund Institute was founded to house the educational and professional activities of Commonfund, and to provide the nonprofit community with investment information and professional development programs. It is dedicated to the advancement of investment knowledge and the promotion of best practices to financial practitioners, fiduciaries and scholars. Commonfund Institute has conducted its annual Commonfund Benchmarks Study for the past 10 years. In addition, it conducts annual research studies into the investment management and governance practices and policies of foundations, operating charities and nonprofit healthcare organizations. |

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Yale University

Sustainability initiatives large and small, traditional and innovative are greening college campuses everywhere and engaging everyone from presidents to incoming freshmen. (*The New York Times* reported that in a survey by the *Princeton Review* of 10,300 college applicants, 63 percent said a school's commitment to the environment could affect their decision to go there.)

Yale University is implementing a host of sustainability initiatives, perhaps the most visible—and precedent-setting—being Kroon Hall, the home of Yale's School of Forestry and Environmental Studies, the oldest continuously operating U.S. school devoted to professional training in environment and natural resources. The 60,000-square-foot building, shown in the inset image as it will look upon opening in early 2009, features south-facing rooftop solar panels, solar hot water heaters, natural light and ventilation, a geothermal energy system, rainwater harvesting system and cleansing pond (expected to save 500,000 gallons of potable water a year), wood harvested from Yale's forests, and recycled, recyclable, sustainably harvested or manufactured nontoxic materials. Demolition and construction waste is being recycled, and green construction materials include "thermally inactive" concrete, low-E glass and insulation, waterless urinals and low-impact paint. Yale anticipates receiving the highest Leadership in Energy and Environmental Design (LEED) Platinum rating for one of the world's greenest buildings. |

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William W. Martin, Chief Risk Officer of Commonfund, authored this issue's cover article on risk management. A member of Commonfund's Investment Policy Committee, he joined the organization in April 2008. Previously, he was Chief Risk Officer of Columbia Management, the investment management division of Bank of America. He is chair of the Global Association of Risk Professionals, an organization with more than 60,000 members worldwide.

Verne O. Sedlacek is President and CEO of Commonfund and the author of the articles, "Assessing the true cost of investment management" and "Rethinking asset allocation." He also contributed the lead editorial for this issue of *Mission Matters.* Sedlacek was named COO and Executive Vice President of Commonfund in 2002, and assumed his present title in 2003. He is also a member of Commonfund's Investment Policy Committee.

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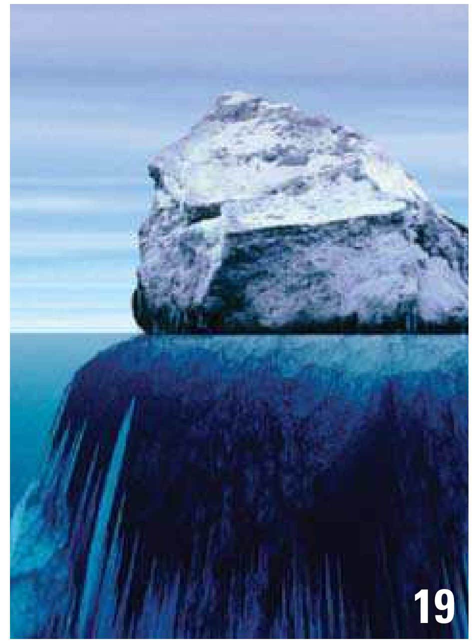

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